Why the current global economic crisis will likely last longer than usual

All indications are that the current global economic crisis is the worst since the Great Depression of the 1930s, in terms of geographical spread, intensity and duration. No country is spared from the wrath, although some countries will feel the heat more than some others. Open economies with small domestic markets, in particular, seem most vulnerable.

Growth forecasts for the world economy now range between 0.5 per cent and 0.9 per cent this year. Many individual country GDP (gross domestic product) forecasts are negative. Economies already slipping into recession include the United States, United Kingdom, Euro-zone members, Russia, Japan, South Korea, Taiwan, New Zealand and Singapore.

One cannot rule out the possibility of these dismal numbers being revised down further before long, as the crisis is still unfolding. The worst is still yet to come. Worse still, there are no quick fixes for the global slump, which means that this crisis will stick around stubbornly longer than usual.

One explanation for this frightening prognosis is that this crisis does not represent a purely cyclical phenomenon of the usual boom-bust roller coaster variety, where ups and downs are dramatically swift. This crisis has been brewing for a long time unnoticed by analysts who were focused on short-term fluctuations.

Serious fault lines have developed in the world economy over the years with severe imbalances of sorts between savings and investments, production and consumption, revenue and expenditure, as manifested in the widening current account imbalances, and growing budget deficits, not to mention the extremely unstable exchange rates, interest rates, and asset prices which the world has witnessed in recent times.

Seen in these terms, the global crisis is a combination of both cyclical and structural problems. The latter requires painful microsurgery, including major institutional reforms, which do take much time, quite unlike macroeconomic countercyclical interventions. What is more, studies have shown that economic crises preceded by financial crisis, which is indeed the case with the US now, tend to drag on and on.

The task for policymakers under such tough circumstances is extremely daunting. Even the relatively easier macroeconomic policy interventions are not going to be that easy, as policymakers continue to face fewer policy options. Put another way, the policymakers are running out of ammunitions to fight the crisis.

The three main tools used during economic meltdowns are monetary, fiscal and exchange rate instruments, to stimulate a faltering economy. In the monetary policy domain, the central bank would reduce interest rates and relax statutory reserve requirements so that banks can lend more, resulting in increased consumer spending and investment expenditure which would augment economic growth.

In the fiscal realm, the treasury would reduce taxes and increase public expenditure at the risk of budget deficits, not only to increase the disposable income of the people so that they will spend more, but also to pump-prime the economy through increased government expenditure that would take up the private sector slack.

An appropriate foreign exchange rate policy under such circumstances would be to opt for a weaker currency, aimed primarily at external demand, as this would render exports competitive and divert domestic demand away from imports to local substitutes.

Unfortunately, the reality on the ground now in most countries, especially the United States, is that all three instruments are somewhat blunt if not impotent. Interest rates are already at low levels close to zero in Japan and the US, while in many other countries they hover at historically low levels. Interest rate cuts would work well, only if interest rates are high to begin with and the rate cuts are substantial. Given the near-zero interest rates, further rate cuts can only be marginal with little impact, for nominal interest rates cannot fall below zero.

In the US, real interest rates are negative, given the higher rate of inflation relative to nominal interest rate. In a recessionary setting, inflation tends to give way to deflation, with falling prices, in which case the interest rate would rise in real terms by becoming less negative than previously, thereby raising the cost of borrowing. In other words, the end result will be the opposite of what monetary easing is supposed to accomplish.

The picture is quite similar for the fiscal instrument as well. Many countries, including Japan, India, Malaysia and the US, have been running large budget deficits even in good times year after year. Increased budget deficit through tax reduction and/or expenditure hike, in such cases, may only have limited impact due to fiscal fatigue. A budget deficit of, say, 5 per cent of GDP would have significant impact for an economy starting with balanced budget, but not for an economy already saddled with a deficit of 4 per cent of GDP.

Where monetary and fiscal measures do not work well, the foreign exchange rate mechanism can help, if there were no constraints on exchange rate changes. Thus, an exchange rate devaluation or depreciation would increase demand for a country's products both at home and abroad by making exports cheaper and imports dearer.

In theory, a country's currency would depreciate in the wake of an economic slump, but this is not the case with the US dollar, which has been strengthening in recent times defying gravity. The dollar could stay strong, despite US economic woes, thanks mainly to massive capital inflows into the US, as the US continues to borrow, and others wanting to keep the dollar strong so that they can continue to export to the US and at the same time protect their reserves from a possible collapse of the greenback.

No way can the US economy recover rapidly so long as its currency remains unrealistically strong. The dollar will have to depreciate significantly for the US to produce more for exports and to divert its insatiable demand toward American products. Thus, exchange rate corrections are needed, not only to reduce the US current account deficits but also to stimulate domestic production for both external and internal consumption. This, however, is unlikely to happen anytime soon, given the global addiction to the greenback, and hence the failure of the exchange rate instrument.

With all three major policy tools, namely monetary, fiscal and exchange rate, reeling under heavy sedation, the chances of a quick recovery are quite slim. The writings on the wall thus suggest that the crisis will stick around for at least two years, if not longer.

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