Rebalancing the Economy: What’s Next?

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Abstract— The financial crisis that started with subprime in August 2007 will raise many questions about what Wall Street can be allowed to do in the future and how it will be regulated. Governing the market is a fundamental responsibility given the systemic risks they pose. In 2009, industries struggled to cope with the most severe economic decline in half a century hit by excesses of capitalism and modern finance. Rebalancing the economy so as to rebound is clearly the priority for economies around the world.

Index Term— financial crisis, policies, risks, governance, market

I. INTRODUCTION

Economic growth prospects or another slowdown?
Sales of previously owned US homes jumped to the highest level in nearly three years in November 2009, the latest sign the economic recovery was gaining steam after growing below expectations in the third quarter. According to The National Association of Realtors (NAR), the existing home sales rose 7.4% to an annual rate of 6.54 million units in November. It was the fastest pace since February 2007. Separately, the Commerce Department said US gross domestic product (GDP) grew at a 2.2% annual rate in the third quarter instead of the 2.8% pace reported in November 2009. Economists had thought the final estimate of GDP, which measures total goods and services output within US borders, would hold steady at 2.8%, and GDP growth of 3.5-4.0%. The housing market, the main trigger of the most painful US recession in 70 years, is stabilizing and even more heartening, the decline in home prices is fading. The median home price fell 4.3% in November from a year ago to US$172,600, being the smallest drop since November 2007. A separate report from the US Federal Housing Finance Agency showed home prices rose 0.6% in October from September [1]

On the other hand, Nobel Prize-winning economist Joseph Stiglitz said that the United States needs to prepare for a second stimulus package as there is a ‘significant’ chance that growth will slow in the second half of 2010. According to him, the world’s largest economy was not likely to expand fast enough to create jobs for new entrants into the labor force or compensate for increases in productivity that would reduce demand for workers. Stiglitz’s comments echo the view of Nobel Laureate Paul Krugman and counter the Obama administration’s judgment that it’s premature to consider another stimulus package after 2009’s US$787 billion measure. President Obama has instead praised a more limited, US$154 billion plan approved by the US House aimed at shoring up the job market. The worst US recession since the Great Depression has drained more than seven million jobs in the past two years. The government and the Federal Reserve have spent, lent or committed more than US$10 trillion to revive the economy and credit markets. Fed policymakers project a decline in the unemployment rate to a range of 9.3% to 9.7% in the fourth quarter of 2010. The US economy expanded in the third quarter of 2009 for the first time in a year at a 2.8% pace as government incentives spurred consumers to spend more on homes and motor vehicles [2].

II. BAILOUTS AND PROPERTY BUST

The American International Group (AIG) bailout was one of the largest in history, with the US government injecting more than US$100 billion into the company. The bailout was brought about by AIG’s large losses on derivative transactions with financial institutions, mostly sophisticated players such as Goldman Sachs and Sapin’s Banco Santander. After the government’s infusion of funds in September 2009, AIG’s losses continued to mount, so the government provided substantial amounts of additional capital two months later. A reorganization of AIG and a shift in its ownership should not have been expected to endanger insurance policyholders. The insurance subsidiaries were not responsible for the obligations of their parent company, and their claims toward policyholders were backed by required reserves. In any event, concerns about insurance policyholders should have led, at most, to a governmental commitment to back their claims if necessary. It did not require taxpayers to bail out the parent company’s derivative counterparties. The government might also have been motivated by concerns that losses to the derivative counterparties would deplete the capital of some significant financial institutions at a difficult time. Again, such concerns would have been better addressed in different ways – in particular, by providing institutions that needed capital with funds directly, and in return for securities. In the future, governments should not bail out failing financial institutions’ derivative counter-parties, even when they provide a safety net to some of these institutions’ creditors (such as depositors). Governments should not only follow such a policy, but also make absolutely clear in advance their commitment to doing so. Communicating such a commitment clearly would induce parties to their transactions not to rely on a governmental safety net, but to monitor whether their partners have adequate reserves. A governmental commitment to exclude derivate creditors from any safety net extended when financial institutions fail would reduce future costs to taxpayers from cases like AIG.

In the past year, moral hazard appears to firmly appear throughout the global financial system. Recent developments from the sharp rise in risk premium for Greek bonds and Turkish as well as Hungarian credit default swaps (following their profound budget mess) to the Dubai World as investors fled from risks. In the wake of the Dubai debacle, it looks like

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Dubai is set to make investors suffer. Dubai World was technically not government-backed but investors had perceived it to be so and acted accordingly. Markets soon realized that debt fundamentals in Dubai are no different from those in developed nations. Indeed, the line between emerging and developed gets more blurred; the rush to judgment that stability has returned is premature given that fundamental imbalances remain during the crises such as excess leverage have yet to disappear and huge vulnerabilities remain. According to Reuters, Dubai World is likely to press for more time to restructure its US$22 billion debt so markets can recover which will ease credit conditions and enable it to sell assets at higher prices. Dubai World and its lenders are betting on a market upturn that would alleviate the company’s debt concerns and improve the chances and terms for selling some assets to generate cash. The complexity of Dubai’s World debt structure, with some 90 creditors, coupled with the fact government financial support is contingent on an acceptable standstill deal, means the company will have a tough time holding off their creditors.

Since the 1950s, Dubai has relied on diversifying its economy, service orienteering it from ports and trade to services and finance. In the last decade, however, its liquidity-fuelled real estate and tourism is now showing that Dubai’s phenomenal economic emergence is vulnerable. Nakheel, a government-sponsored developer, used funds to develop the Palm Islands and other spectacular land reclamation projects and is due to repay US$3.52 bil to holders of its Islamic sukuk bonds. This is part of the US$26bil debt that is parent, Dubai World, is seeking to restructure. In all, Dubai’s sovereign and its state-controlled companies’ debts could reach US$80bil, in excess of the size of its GDP. Research shows that Dubai Holding and Dubai World together hold 60-70% of Dubai’s debt, conservatively estimated at 180% of Dubai’s GDP. Bank of America Merrill Lynch thinks Dubai Holding has US$1.8bil due for repayment in 2010 and Barclays Capital further emphasized that Dubai Holding was most at risk of defaulting on its debt after Dubai World. That is because it has extensive property assets, over-inflated in value, with property values having been halved in the last year and remains highly leveraged. This crisis has also done a disservice to the sukuk market, at the very least, short-term activity in sukuk will remain stalled [3] What’s unclear is if any of the restructuring will lead to business and financial transparency. In relation, who will lead the change for good governance and transparency?

The United States seized the two mortgage financiers in 2008 as the government struggled to prevent a meltdown of the financial system. The debts of Fannie Mae, Freddie Mac and the Federal Home Loan Banks grew an average US$184bil annually from 1998 to 2008, helping fuel a bubble that drove home prices up by 107% between 2000 and mid-2006, according to the S&P/Case-Shiller home price index. The Treasury said on December 24 2009 that it would provide an unlimited amount of assistance to the companies as needed for the next three years to alleviate market concern that the government lifeline for Fannie Mae and Freddie Mac, the largest source of money for US home loans, could lapse or be exhausted. Lax regulation of Fannie Mae and Freddie Mac led to the mortgage companies taking on too many risky loans. In the United States, the S&P/Case-Shiller index of prices in ten big cities was unchanged in October 2009, after five monthly increases. That has left prices 6.4% below their levels 12 months earlier. Another index from the Federal Housing Finance Agency, the regulator of Fannie Mae and Freddie Mac, says that the price-to-rents ratio is still some 14% above its average as reflected in Fig. 1. below[4].

<table>
<thead>
<tr>
<th>Country</th>
<th>Latest</th>
<th>Q3 2008</th>
<th>1997-2009</th>
<th>Under(-)/over(+) valued</th>
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<tbody>
<tr>
<td>Hong Kong</td>
<td>13.9</td>
<td>18.5</td>
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<td>China</td>
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<td>5.3</td>
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<tr>
<td>Australia</td>
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<td>1.4</td>
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<tr>
<td>South Africa</td>
<td>4.8</td>
<td>2.5</td>
<td>418</td>
<td>na</td>
</tr>
<tr>
<td>Switzerland</td>
<td>4.1</td>
<td>3.7</td>
<td>28</td>
<td>-9.0</td>
</tr>
<tr>
<td>Britain</td>
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<td>175</td>
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<tr>
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<tr>
<td>Germany</td>
<td>-3.9</td>
<td>-0.5</td>
<td>na</td>
<td>-15.2</td>
</tr>
<tr>
<td>Japan</td>
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<td>-1.8</td>
<td>-36</td>
<td>-33.7</td>
</tr>
<tr>
<td>United States (FHFA)</td>
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<td>+14.0</td>
</tr>
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<tr>
<td>United States (Case-Shiller ten-city index)</td>
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<td>Singapore</td>
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<td>8.3</td>
<td>-4</td>
<td>na</td>
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<tr>
<td>France</td>
<td>-8.0</td>
<td>0.8</td>
<td>132</td>
<td>+39.8</td>
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</table>

Fig. 1. House-price indicators (% change)

Source: The Economist, January 2nd-8th, 2010
Finally, one wonders when the next global financial crisis is and what could be its source? Clarity on the road-map to government prudence over the longer term is needed which includes a credible plan on debt management as global recovery is to become sustainable. Credibility in the restructuring exercise will determine the future.

China’s boom or ‘full-blown bubble’?
On the other side of the world, China’s benchmark stock index rose to its highest level with net income rose 7.8% in the eleven months through November 2009 from the same period a year earlier, to 2.59 trillion yuan, according to statistics bureau in Beijing. China raised it 2008 growth estimate to 9.6% from 9%. According to Bank of America Merrill Lynch Research, China’s stock and property markets may develop into a ‘full-blown’ bubble in 2010 as inflation accelerates. The government’s four trillion yuan stimulus spending and record lending helped spur a revival in the world’s third largest economy. Property prices have risen too quickly in some areas and the government should use taxes and interest rates to...
stabilize them. China’s industrial production grew in November 2009 at the fastest pace since March 2008 as property sales climbed and government subsidies supported consumer spending. According to a Bloomberg News survey of economists, GDP will expand 8.5% in 2010. Stimulus spending and a record US$1.3trillion of new loans in the first 11 months of 2009 are driving up demand. China’s economy is leading the recovery in Asia. Manufacturers reporting higher earnings include China Resources Enterprise Ltd, the Chinese partner of SABMiller plc, and Beijing Automotive Industry Holding Cp, which is buying technology from General Motors Co’s Saab unit to speed the development of own-brand models to meet growing domestic demand. Electricity companies’ profits more than tripled as Datang International Power Generation Co and Huaneng Power International Inc tapped increased demand. The nation is poised to overtake Japan as the world’s second-biggest economy in 2010 according to the International Monetary Fund. [5]

**Liquidity Assets: A Step Forward?**

Switzerland may be the first country to introduce rules requiring banks to keep more liquid assets on hand following the global credit crisis. Forcing Zurich-base UBS AG and Credit Suisse Group AG to hoard more cash and low-yielding securities against a possible bank run would make them less profitable and may lead them to curb lending. The Swiss Financial Market Supervisory Authority, as a regulator planned to publish new liquidity management rules in the first quarter of 2010 and banks will have to implement them in the second quarter. Stricter liquidity rules take away the flexibility of the banks in lending that may lead to fewer loans being made and lower profitability as less interest income is generated. The rules as currently envisioned would only apply to the two largest banks, because of concern a collapse of either would endanger the Swiss financial system. Swiss regulators have been in discussions with banks to update liquidity rules since before the crisis. The urgency grew when credit markets froze after Lehman Brothers Holdings Inc’s bankruptcy in September 2008. The Swiss government had to support UBS with six billion francs (US$5.8bil) in capital to help it spin off risky assets into a Swiss National Bank fund. The Bael Committee on Banking Supervision said it plans to develop a set of minimum standards for capital and liquidity by the end of 2010, with the aim of implementing them by the end of 2012. The committee proposed introducing a minimum coverage ratio to ensure that banks can meet their liquidity needs for a 30day period in a stress situation, as well as a ratio to measure the amount of longer-term stable sources of funding used by companies [6].

**III. UNEMPLOYMENT AND JOBLESS CLAIMS**

As 2009 drew to a close, some 460,000 workers applied for jobless insurance payments in the week ended December 26, up from a one-year low of 452,000 a week earlier, according to the median forecast of 27 economists surveyed by Bloomberg News. It would mark the sixth consecutive week of less than 500,000 claims, the best performance since 2008.

This points to an improvement in the labour market that will help sustain economic growth in 2010. Companies are retaining staff as sales improve and production picks up. Gains in consumer spending, which accounts for 70% of the economy, may encourage more hiring in coming months, helping to bolster the rebound from the worst recession since the 1930s [7].

**What’s Next?**

The current consensus is that the present global monetary structure is flawed and unsustainable. As the issuer of the reserve currency, the United States provided the world with ample liquidity but at the cost of running larger current account deficits. The role as world’s consumer of last resort enjoyed global support as countries like Japan and Germany were willing to finance that deficit. In the case of the United States, it over-extended its leverage in the financial sector, had a bubble deflation and now needs to rebuild its balance sheet by deleveraging and increasing domestic savings. The economy would be more sustainable if more resources were devoted to evaluating distorted prices of goods and services, taxation, and subsidies and correct the tool ineffectiveness and institutional misalignment. What also need rebuilding are the underlying serious differences of perspectives on the crises and solutions respectively in economic thought and philosophy within the West and between the East and West. The major concerns continue to be how sustainable the recovery would be in the world economy and G7 countries. The events surrounding Dubai World continue to bear witness to the volatility of the markets and governments around the world are thinking of withdrawal of fiscal stimulus and other measures as they economies recover. Export-reliant nations such as Malaysia were hit by drastic drop in demand, will be slow to recover. It is encouraging domestic demand, which for most usually comes from direct government spending initially but is now gradually moving towards private consumption. However, asset deflation is not a problem yet for Malaysia. Policy announcements have been made in the liberalization of the services and financial sectors but awaits results as there continues to be disparities between policy rhetoric and action. The low interest rates are seen to be fuelling the emergence of new asset bubbles, particularly in Asian economies such as China, Hong Kong, South Korea and Singapore, where property and equity prices have surged beyond what their fundamentals justify. There is also money chasing commodities, such as gold and crude oil, as investors seek to invest in assets that promise higher returns resulting in the prices of major commodities rising sharply. The other concern pertains to the rise of inflationary pressure. The general price level of goods and services could accelerate as total demand in an economy continues to grow with the improving economy or as the rise of commodity and raw material prices continue to push up costs. While the consensus view is that inflation is still a subdued risk for most economies at this stage, the next few months can present a different story. For example, the United Nations Food and Agriculture Organisation warned that global food prices had bounced back
to a 14-month high last November, one of the signs of rising inflation risk. Amidst the rising risk of new asset bubbles and inflation in a more stabilized and improved economy this year, the next sensible move expected is to raise interest rates before their economies get overheated. The uptrend of interest rates could also slow the rise of equity prices which is good to prevent equity prices from overshooting beyond their fundamentals. Certainly the change in interest rates has a broader implication on the economy. Many economists agree that the current financial and economic crisis is attributable to, partially the fact that important central banks such as the US Federal Reserve and Bank of England kept their key interest rates too low for too long leading to a long period of double-digit growth of money supply. As the current crisis clearly shows, sooner or later too much money will lead to excesses in consumer price inflation, then in asset price inflation and disappearance of risk premium. Consumer demand is seen as key to the post-crisis global recovery. What is happening is a rebalancing of global consumption, away from advanced economies and driving towards emerging markets like China, Brazil, Russia, and India. Big stimulus programs in Russia, Hong Kong, Malaysia, Vietnam, Singapore, Brazil and Thailand and of course China has unveiled large anti-crisis budgets. As in any case, if any change is necessary, a gradual one is vital to prevent any economic shocks. Anyone’s guess is that for the beginning of a new year, the outlook tends to be bullish despite complexities! Perhaps rebalancing the economy is the priority of every country and awaits the next change given the vulnerabilities and myriad ways of doing so but strikingly have not led to any political instability.

REFERENCES

BIOGRAPHY
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