WORLD ECONOMIC CRISIS: IMPLICATIONS FOR SRI LANKA

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Crises are an integral part of the evolution of market economies. All major industrial economies of the world have gone through periodic financial crises which from time to time turned into more generalized economic crises. *Yet the current crisis is universally recognized as different, on a scale that is comparable only to the global breakdown of production and trade in the 1930s, a once-in-a-century event.* While many people in Sri Lanka are concerned about the effects of the global credit crunch in depressing prices and demand for our exports, the greater danger that lies ahead appears to be less well appreciated.

The overriding concern for people in Sri Lanka is the question of how the unfolding world economic crisis will affect the Sri Lankan economy. It is difficult to give a definite answer since the depth and scope of the world crisis is still not clear. The consensus view among informed observers worldwide is that the current breakdown has the potential to develop into a worldwide depression on the scale of the 1930s Great Depression (GD). That GD was triggered by the Wall Street crash of 1929, but had other causal drivers besides a collapse of confidence in the integrity of the financial system.

The hope is that now since leading economic policymakers know much more about the mechanics of crises and the various errors of omission and commission made in the 1930s GD, they would be able to substantially mitigate the adverse impact and its persistence in time. Towards that end, the governments of the major industrial countries along with China and India are working in concert to stave off the worst effects of the crisis and restore stability in the international financial system.

It is important to emphasize, however, that no amount of coordinated action can guarantee that the world will not slide into a depression, though it seems unlikely that it would last as long as the first GD which ended only with the onset of the Second World War in 1939. The best case scenario is a worldwide recession lasting a couple of years. In the likeliest worst case, it may extend over a period of about five years.

The smooth flow of finance is necessary for the "real economy" of production and consumption to function smoothly. Financial flows are volatile and unstable since these are largely determined by price movements of financial assets (stocks, bonds, etc.) that are driven by market psychology. Asset prices can inflate way beyond real rates of growth, thereby creating asset price bubbles. Bubbles inevitably collapse at some point resulting in runs on banks that are over-exposed to such assets, which leads to the freezing up of credit for all economic activity which in turn leads to curtailment of production, consumption and trade which results in job losses and corporate bankruptcies. This winding down of economic activity generates a recession or amplifies a recessionary trend, which spills over into trading partners through reduced demand for exports. Many countries are now caught up in this descending spiral of generalized recession of production and trade which in turn generates job losses and corporate bankruptcies.

Much of the action taken so far in the US and other industrial countries has been directed towards restoring confidence in the financial system, so as to prevent a winding down of the real economy in the longer run. Measures taken so far appear inadequate, since financial instability has not eased in the West or the East. In theory, financial market integrity could be fixed relatively quickly by taking over the international financial system by a consortium of major industrial country governments and operating it like a 'global public good,' or more correctly, a global public service. In fact, some small steps in this direction are being taken already. What is holding back such a measure is of course the prevailing ideology of the desirability of minimal state interference in the operation of markets. In the end, it may well lead to this outcome since the alternative of descent into a global depression is too awful to accept. To save the real economy, it may become necessary to tightly regulate the international financial system. This will not eliminate capitalism, but it will constitute a radically new stage in the historic evolution of the capitalist system.
The first question is how the nature of the present global crisis is to be apprehended. There is scant empirical material to guide predictions and there is no universally accepted theory. Much of theory in economics is based on equilibrium

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concepts and a crisis is a disequilibrium event that does not lend itself to conventional analysis. We just have to start with the first cataclysmic global economic crisis, the Great Depression of the 1930s, and then see how the present situation is different.

A more comprehensive account of the current crisis would discuss its immediate causes and the economic mechanisms that drive its longer term dynamics. This is not possible here given limits imposed by the editors. In any case the innovations in the US financial system, such as mortgage based securities and credit default swaps, that precipitated the financial breakdown are being written about in the main stream press. What is important to note here is that these are the result of relaxation of regulatory controls on the financial system which have induced the finance industry to develop instruments that enhance returns to themselves, but which also greatly raise systemic risk. While the mandarins of finance reaped super-profits, the taxpayers through their governments are compelled to bear the cost of restoring stability to the system.

The other major topic left out is an exposition of why crises take place and the dynamics of their evolution. This would involve a technical analysis of sources of instability in the financial sectors of the economy, in particular the positive feedback mechanisms that amplify positive and negative shocks to the system. We would also need to go into controversial economic arguments since there is no widely accepted explanation of such deep crises. Simple explanations, such as the 'falling rate of profit' offered by doctrinaire Marxists, can be easily dismissed since major crises are most often preceded by periods of rapid technical change and market euphoria related to elevated profit rates. Austrian and monetarist explanations such as the over-expansion of the money supply are also not credible since expansion seems to be driven by more fundamental determinants. Such issues are not raised here since the main objective of the article is to discuss the impact of the crisis on Sri Lanka.

The Great Depression of the 1930s

Apart from cataclysmic crises like the GD and the present world crisis, normal crises, while wreaking havoc on the productive forces of the economy, play a positive role as well. They highlight weak links in the banking system, the industrial system and to some extent in the governmental regulatory structures. If correctly identified and addressed, the economic system is thereby strengthened. This is the essence of the evolutionary perspective adopted here, where episodic crises are seen as a self regulating mechanism by which structural and institutional flaws that need correction are placed on the immediate agenda for reform. But the GD was a systemic breakdown of a different order.

The GD was centred in the United States, but spread to most of the major industrial nations that were linked by strong economic ties to the central system. Japan, which at that time was less closely integrated with the Western industrial economies, was consequently much less affected. Germany was very badly hit and the economic misery generated there undoubtedly enabled the Nazi Party under Hitler to assume state power as the saviour of the nation. Some of the raw statistics that highlight the state of economic collapse in the United States are listed below.

- The stock market crash of 1929 caused the New York Stock Exchange to lose 25% of its value. One index of stock prices, the Dow Industrial Average fell from 381 to 41 between September 1929 and July 1932.
- The US was racked by a record number of bank runs and bank failures which contracted the money supply even further leading to sharp falls in production.
- 25% were unemployed at the height of depression in 1933 and high unemployment lasted for all of the 1930s and fell below 10% only in 1941 when production for the war expanded.
- Real GDP fell by around 30%, industrial production fell by 45% and the price level fell by 24%.
- Real GDP fell by 20% in Germany, 16% in France and 6% in the UK.
- People cut back consumption, businesses held back investment – in a self-sustaining cycle.

Financial crises and recessions are of course a normal part of the operation of capitalism. The post Second World War period has seen a number of crises at regular intervals, the biggest of which was the Asian crises of the 1997-98 period. The economies that were fundamentally strong as regards the real production base and institutional structure, such as South Korea, Taiwan, Singapore and Hong Kong, recovered fairly quickly. Weaker economies like Thailand and Indonesia took much longer and had to put in place much more comprehensive institutional reforms and regulatory controls, before regaining a measure of economic health.

In the 19th century as well there were many smaller, limited crises in the US and Europe; but these were not of much

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consequence since they were confined within smaller geographic regions and these regional economics were not too tightly bound together, even in the continental US. By 1929 the world economy was much more closely integrated following a wave of major technological changes in the US and Germany, the advance of British and French imperialism across the world and rapid growth in world trade and cross-border investment. But integration had come about in a mostly ad hoc fashion with weak institutional support for trade, investment and financial flows. This structure was rent apart by the financial crisis in the US following the 1929 crash and rebuilt with greater care following the Second World War.

The present situation and likely outcomes

The world economy is very substantially different today from what it was in the early 20th century and governments now have more capability and understanding to deal with major crises. On the negative side financial flows are relatively larger, more complex and constitute a greater threat.

- The productive base is enormously stronger and technologically much more advanced, especially in the developing or 'emerging' regions of the world.
- The world economy is much more spread-out, possibly even more resilient with a large role played by strong emergent economies like China, India and Brazil. In other words, the relative role of the US economy in the world is smaller in quantitative terms. Most importantly, the so-called developing world has been growing very strongly over the last two decades or so and has the capacity to expand its domestic markets very substantially and upgrade production technologies which could create extra demand for capital goods from the advanced countries. Hence demand does not have to collapse all round as it did in the first GD. But, again, this is not going to happen automatically, but only in response to carefully coordinated action by all.
- Economic policymakers know a lot more about how destabilizing macroeconomic forces work, as a result of the lessons of the GD of the 1930s, though arguably not enough. Hence it is likely that they will avoid some of the crasser mistakes of the previous event such as letting too many banks fail which severely constricted the money supply and thereby exacerbated the credit crunch on the productive economy.
- The GD of the 1930s was totally unexpected by the policymakers of that time, who thought that it would automatically resolve itself fairly quickly like minor crises. Therefore, governments did nothing for many years. Today, that situation has changed. Governments of all major industrial nations have acted very quickly to stave off bank failures, guarantee deposits and even take over failing banks and other failing financial institutions to limit the damage. Policymakers are aware of the likelihood of a catastrophe. Moreover, all governments have acted in close coordination, with even the Chinese recognizing that they have much to loose from a GD-style breakdown.
- On the negative side, financial markets and flows are relatively larger and more integrated throughout the world. Given the deregulation of financial markets over the last two decades in the US and elsewhere, they constitute a greater source of instability. In fact, the current crisis began with the collapse of the US housing bubble which was financed through sub-prime loans that were securitized and sold throughout the world.

As a result of all of the above, it is not likely that the long-drawn out resolution of the 1930s GD will be repeated this time. In general, it is a fair claim that history never repeats its events exactly. Yet there are major weaknesses to address, not least the collapse of confidence in the financial system and the capability of the leaders of finance. These weaknesses will take many years to address, though of course the world economy could continue to expand at a reasonable rate well before all the issues are settled. The likely best scenario is about two years to return to some form of stability. The worst case would extend this to perhaps five years. But these are guesstimates at best and there are troubling issues which could overturn such expectations. These problems derive from underlying imbalances driving the origin and propagation of economic crises.

Likely effects on Sri Lanka

The present global crisis is hitting Sri Lanka – and South Asia in general – at a time when the region is already suffering from adverse movements in the terms-of-trade, i.e. a decline in the price of exports relative to the price of imports. These countries have already made major adjustments, but the adverse impact – rising inflation, worsening trade and fiscal deficits and slowing growth rates – has been severe. Sri Lanka's high fiscal deficit – around 7% in 2007 – has risen even further in 2008. Inflation is running at 25%, the highest rate in South Asia, driven mainly by food and fuel prices and the budget deficit driven by extraordinary military expenditure.

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These pressures have eased somewhat in the last few months as food and fuel prices have fallen.

The crisis has already had significant effects on major Sri Lankan exports. The financial crisis has led to a severe credit crunch which has reduced the ability of importers to obtain trade credits. This has reduced demand for all commodity imports, including tea and rubber. Demand for rubber has also fallen as a result of recessionary trends, though not in China and India. Tea and rubber prices have declined sharply over the last month or so, thereby reducing our foreign exchange earnings and imposing hardship on tea and rubber exporters. The credit crunch will also affect the export of garments, another major export of Sri Lanka. These problems come in the wake of a commodities boom in the earlier part of the year which had sent tea and rubber prices to record highs.

In general terms, an economic crisis could affect a trade-oriented developing economy like Sri Lanka in the following ways. These track the different ways in which the smaller, dependent economy is connected to the world economy.

Trade channels: exports and imports of goods and services including tourism
Any decline in economic activity in the major markets of the world, that is a recession or depression, will inevitably reduce demand for exports and thereby reduce the capacity of the country to import. Since recessionary trends are just beginning in the US and Europe, the main impact has still to be felt in the local economy. Clearly the effect will depend on the depth of the recession in the industrial economies of the world. Exports will fall off to the extent that recessionary trends spread to our major trading partners.
Imports will be affected as a result of the falling off in export earnings, though import prices are now falling. Lower commodity prices, including the price of petroleum, could positively affect the trade balance. It is likely that tourist arrivals will also fall away as the recession bites deeper. This may not be a very significant effect since earnings from tourism are already down on account of the impaired security situation in the country.

Remittances from expatriate workers
This is currently the country's largest source of foreign exchange earnings and one that has been growing rapidly. They are also a major source of livelihood support for poorer households in Sri Lanka. Since most remittances are from lower skilled workers employed in the Middle East, which has built up large reserves, these are not likely to be affected in the short-to-medium term. It is hard to predict what will happen in the longer term since much depends on how the crisis will play out in the next few years.

Financial channels
Sri Lankan companies and individuals are not directly exposed to the international capital markets on account of restrictions on capital account transactions. The role of foreign capital in financial markets is limited. Hence the fallout from toxic subprime mortgage backed securities is not likely to affect domestic financial institutions. There is likely to be a reduction in external capital flows to both the private sector and the government. Currently the money supply is being tightened to counter inflation; this, together with increased demand for domestic finance, could lead to a slowing down of economic activity. Sri Lanka will avoid the worst effects of financial instability because it is a lower-middle income country and therefore not closely integrated into the global financial system.

Inward investment, including aid from development agencies
Inward private investment will likely fall, partly as a result of contagion effects as investors lose confidence in all equity markets and riskier foreign projects. Since Sri Lanka was never a very hot prospect for inward capital flows, the quantitative impact of such trends is likely to be small.

As regards development assistance, this will depend on the policy responses of major industrial nations. When the financial turmoil has been quietened, much of their resources will be directed towards stimulating demand in their domestic economies. It would, however, be extremely unwise to reduce development assistance to lower and lower-middle income countries since they constitute an important source of demand for advanced country exports. In fact, development assistance could possibly increase, especially that component coming from private sources like the Gates Foundation which has been giving on a scale matched only by rich country governments. Stimulating faster growth and technological upgrading in the developing world would actually boost production and employment in the industrial countries, which have a comparative advantage in the export of technology-intensive capital goods.

Conclusion: desirable global and local policy responses

It has been stated above that the collapse of the subprime mortgage bubble is only the trigger that initiated the financial crisis which in turn could lead to a more generalized economic

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crisis. The main underlying problem is the existence of an anarchic global financial system that is relatively free of regulation. Called the New Financial Architecture (NFA), it consists of a globally integrated system of giant bank conglomerates and a 'shadow banking system' of investment banks, hedge funds and bank-created Special Investment Vehicles (SIV). By engaging in high-risk activities and dealing in complex securities that were not well understood, the NFA has generated a series of crises that have now led to this global breakdown in financial stability.

The NFA had evolved partly in response to the ever-rising size and complexity of the real world economy. But it was also a child of the recent turn to neo-liberal theology of the omnipotence of 'free markets.' Many leading economists, such as Tobin and Stiglitz, had argued for the need to closely regulate financial markets, especially after crises such as the Asian crisis of 1997-98. Now the urgent and immediate need to restore the integrity of the financial system will bring about extensive governmental control well beyond those called for earlier by the most ardent regulation advocates.

In a very general sense the global crisis indicates that the global system of production, trade and finance has outgrown its existing institutional structure of relatively light and autonomous oversight by a system of nation states. There is an urgent need to set up an international system of integrated regulation over the globalized and integrated financial system, just as in the past a national state was needed to regulate an integrated national economy. Unfortunately, the policy responses so far all far short of this target, but as half-hearted measures fail to arrest the decline, the chances are that the system of industrial nations will be compelled to move further in that direction. It may even become necessary to take over the entire global financial system under the control of a supra-national consortium and run it like a 'global public service.'

Whatever happens internationally, the demands on Sri Lankan policymakers are urgent and very serious. Though the country is relatively immune from direct financial effects, the fall off in export earnings will continue to grow as the recession spreads. Growth rates will fall on account of a combination of reduced exports and fiscal tightening. This is hitting the country when it already has large fiscal and current account deficits and has very little room for manoeuvre. There is an urgent need to cut government spending and promote growth. The government has to look to increased external assistance, especially to finance more infrastructure investment. The country has to also urgently develop new external markets in India, China and other strong emerging economies to partially compensate for losses in traditional markets.

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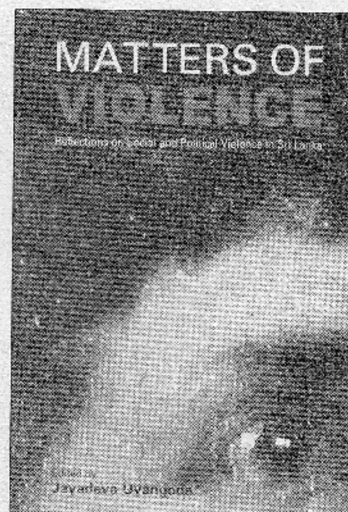

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