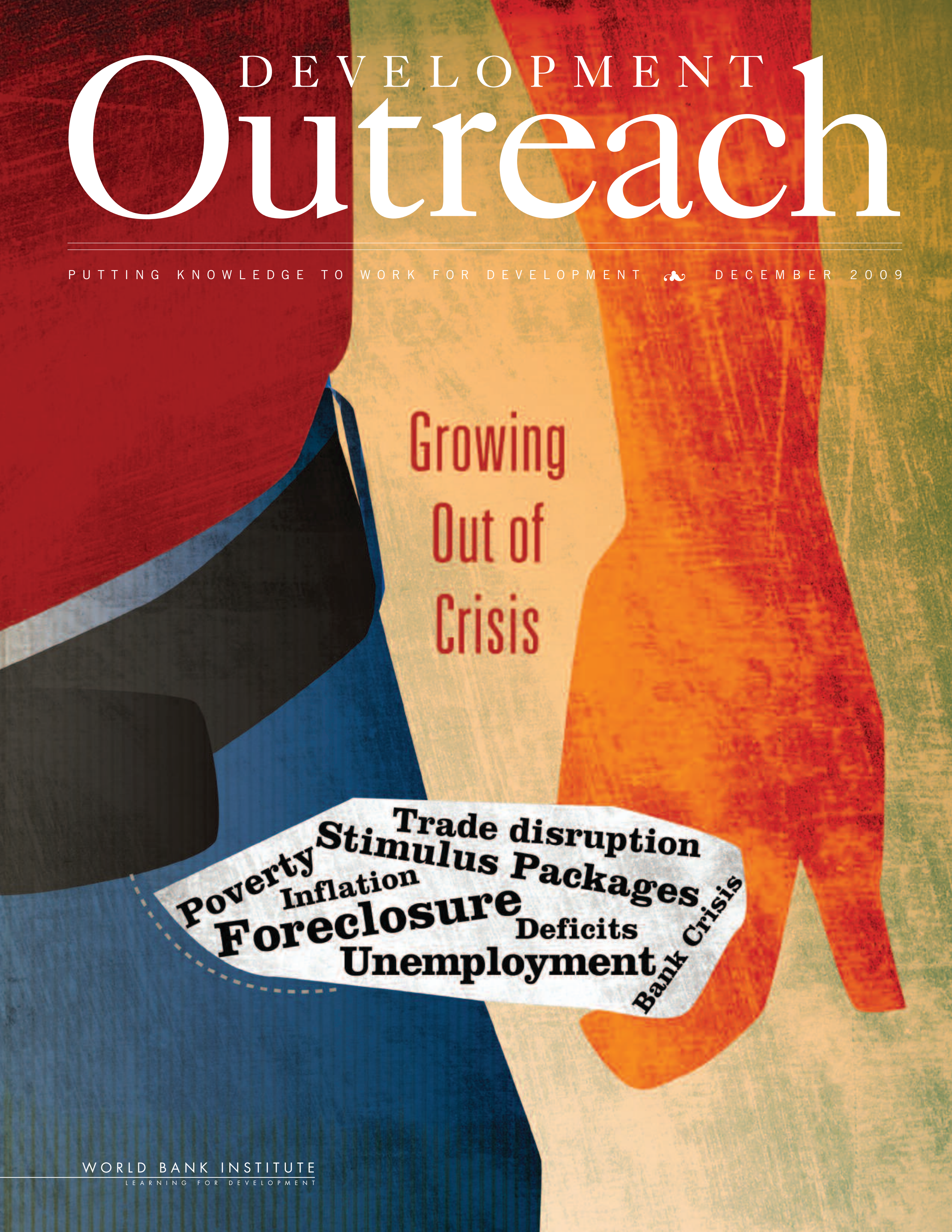
DEVELOPMENT Outreach

PUTTING KNOWLEDGE TO WORK FOR DEVELOPMENT · DECEMBER 2009

Growing Out of Crisis



WORLD BANK INSTITUTE
LEARNING FOR DEVELOPMENT

ABOUT THIS ISSUE

Every crisis has its lessons. A global financial and economic convulsion of the magnitude we have just experienced should offer more lessons than most. That is why we have selected "Growing Out of Crisis" as the theme for this issue of *Development Outreach*.

As 2009 draws to a close, policymakers in all countries are assessing the fault lines in their economic management systems, and working together in international forums such as the G-20 and IMF/World Bank meetings, among others, to define an agenda for reform, and to improve international coordination systems.

We asked some of the world's leading economic thinkers, as well as regional experts and policymakers, to discuss the impact of the crisis from different perspectives and in different parts of the world, and to reflect on changes at national and international levels that would better protect us from the next crisis. The result is a multifaceted picture including some points of disagreement, that provide grist for further debate.

World Bank President Robert Zoellick, in an address at Johns Hopkins University in September, pointed to the vital role of developing economies in leading the world out of this crisis. Indeed, this is perhaps the major watershed produced by the crisis. The emerging market countries have arrived, the G-20 has replaced the G-7, and more hands are on the levers of global economy.

Not least, this has had implications for international financial institutions. The World Bank Group committed itself to lending $100 billion over three years to provide a counter-cyclical stimulus to the developing world. The IMF has also tripled its lending to $750 billion. Both institutions must seek additional support to cover these new demands, and both face pressure to reform their governance and representation to reflect shifting global economic influences.

The World Bank Institute, whose mission includes capacity-building for government officials and other stakeholders, responded to the economic and financial crisis by hosting videoconference discussions among policymakers in developing countries' finance, planning and trade ministries, as well as central banks. A series of seminars, Pathways to Development, will follow, aimed at drawing further lessons to help countries grow out of crisis. For his guest editing of this issue of *Development Outreach*, I would like to thank Raj Nallari.

Christopher Neal
EXECUTIVE EDITOR

Development OUTREACH is published three times a year by the World Bank Institute and reflects issues arising from the World Bank's many learning programs. Articles are solicited that offer a range of viewpoints from a variety of authors worldwide and do not represent official positions of the World Bank or the views of its management.

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PAGE 16

PAGE 32

PAGE 39

SPECIAL REPORT
GROWING OUT OF CRISIS

Shock Producers and Shock Absorbers in the Crisis

BY HANS-WERNER SINN

THE CRISIS ORIGINATED in the United States (U.S.). Since about 1980 the savings rate of U.S. households had fallen from about 10 percent to nearly zero and, because households did not save, the U.S. had to import gigantic amounts of capital from the rest of the world to finance its investments and government budget deficit. Capital imports amounted to 790 billion dollars in 2008. One of the reasons for the decline in savings rates was that the U.S. financial system generously provided mortgages to homeowners, which often was tantamount to hidden consumer credit. The excess of new mortgages over housing investment approached 60 percent in the years before the crisis. Homeowners and banks had jointly speculated on increasing house prices. On top of that, the government with its Community Reinvestment Act had forced banks to lend even to the poorer segments of the population.

After the bubble burst

AFTER THE BUBBLE BURST, house values declined by a third by April 2009, which was a decline in wealth in the order of 6 trillion dollars. The decline in home values was followed by a worldwide decline in other asset values of about 50 trillion dollars because of secondary effects. This has sent shock waves through the U.S. and the rest of the world via three main channels. The first and most important channel was the decline in construction in the U.S., following the decline in the sale of new homes: 75 percent by April 2009. The second was a decline in worldwide consumption because of the wealth effect and the increase in unemployment. The third was a credit crunch resulting from the fact that huge equity losses had forced banks to scale down their lending and investment operations so as to avoid violating the supervisory minimum

Would jumbo loans replace the economic void left by the collapse of the subprime mortgage market?

debt-equity ratios. The U.S. banking system alone had lost 53 percent of its equity stock by February 2009.

The shock waves of the bursting bubble were then mitigated through extensive bank rescue packages in the order of 4.1 trillion euros and Keynesian counter-cyclical budgetary effects in the order of 1.1 trillion euros. The budgetary effects came through discretionary measures as well as through the built-in flexibility of the national tax-expenditure systems. Figure 1 shows the changes in the deficit/GDP ratios from 2008 to 2009 for the OECD countries and thus measures the respective countries' Keynesian stimuli to counteract the world recession.

Fiscal stimuli

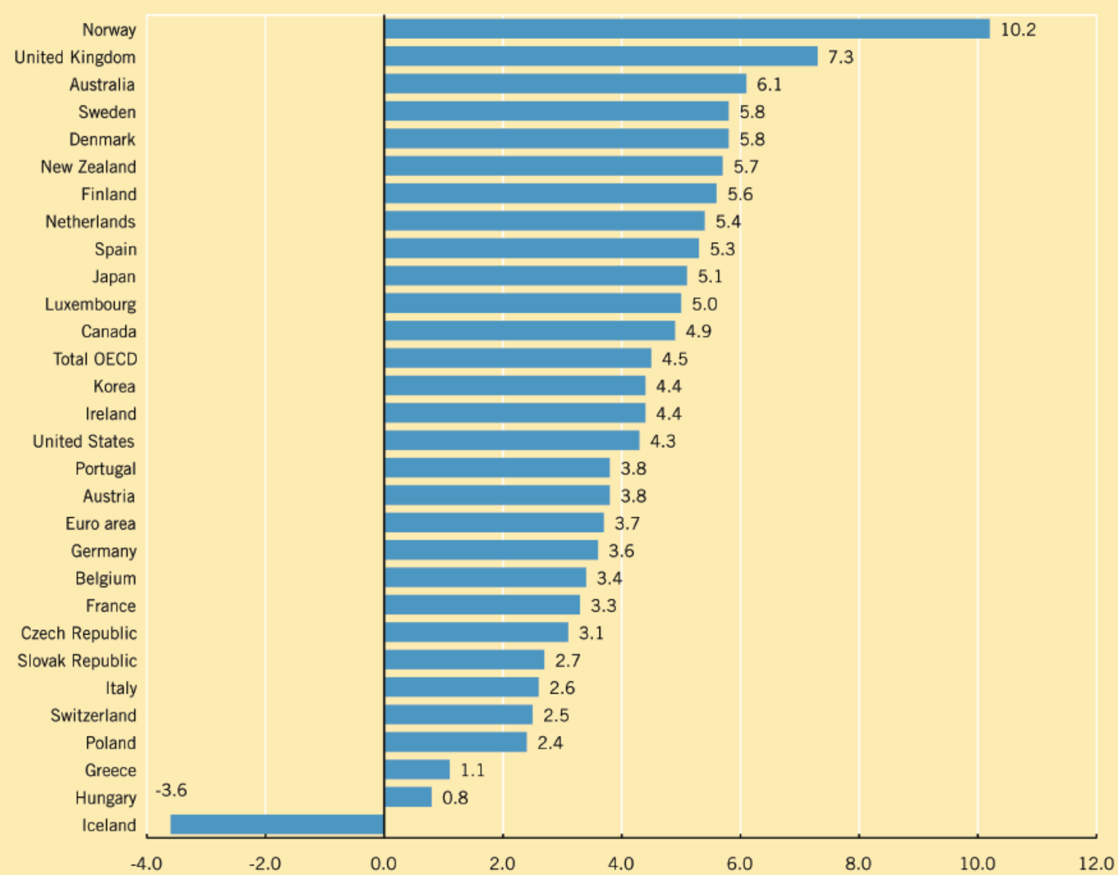
WHILE SMALLER COUNTRIES like Norway, Australia, Sweden, or Denmark are among the countries that have exerted the proportionally largest fiscal stimuli, the U.K. is the outperformer among the big countries with a 7.3 percentage point increase in the deficit share in GDP. On average, the OECD countries have increased their deficit share by 4.5 points, and the euro area has increased its own by 3.7 points. At 4.3 points, the U.S. comes close to the OECD average, and at 3.6 points Germany comes close to the Euroland average. Among the big European countries, France and Italy lag a bit behind with 3.3 and 2.6 points respectively.

In the winter months some international irritation was caused by U.S. officials and scholars accusing Germany of not providing sufficient Keynesian stimuli against the crisis. The data show that there may have been some foundation for this allegation. However, the differences are not particularly large. While it is true, for example, that the U.S. has taken more substantial discretionary measures than Germany, the built-in flexibility of one of the world's largest welfare states has provided an automatic stabilization effect that must also be taken into account. Still, as is shown in Figure 1, the overall U.S. fiscal stimulus was somewhat bigger.

Trade balances

HOWEVER, THIS IS NATURAL since the crisis originated in the U.S. and not in Europe. A more important question for an overall assessment of the situation is, therefore, how large the

FIGURE 1: CHANGES IN GOVERNMENT DEFICIT/GDP SHARES 2008-2009, OECD COUNTRIES, PERCENTAGE POINTS



Source: OECD Economic Outlook 85 database; calculations by the Ifo Institute.

net demand shocks exerted by various countries really were for the rest of the world . This is answered in Figure 2 for a number of countries for which data could be found, including the BRIC countries (Brazil, Russia, India, and China). The graph shows the changes in the respective trade balances from the first quarter 2008 to the first quarter 2009 and hence the net reductions in aggregate demand that were exerted from the respective country to the rest of the world.

It is not surprising that the U.S. has been by far the world's largest shock producer in this crisis. While both its exports and imports fell, its annualized imports shrank by 361 billion dollars more than its exports. More surprising is that China did not reduce its huge trade surplus but increased it even further. Its imports declined by 71 billion dollars more than its exports. China amplified the shockwave coming from the U.S., and so did Brazil, Spain, the U.K., and South Korea, among others.

Shock absorbers

THE BIG SHOCK ABSORBERS on the other hand were Japan, Russia, and Germany, whose exports all shrank more than their imports: by 110 billion, 124 billon and 168 billion dollars respectively. This exonerates Germany from the accusations of free riding in the current crisis. Germany is currently the world's biggest shock absorber.

The reason for this result is that the German economy is still surprisingly stable internally. The welfare state has many allocative disadvantages in the long run, but in a crisis it has a cushioning effect: 42 percent of adult Germans live on government transfers including state pensions, and the government pays short-term work insurance for up to 24 months to employers who keep their employees working at reduced hours during the crisis. Moreover, Germany has had no housing bubble, and its mortgage system is particularly safe and stable. Germany has long-term fixed interest loans, extremely tight credit constraints for home owners (loans rarely exceed 60 percent of a home's value), and double-secured, mortgage-backed securities (Pfandbriefe) that give buyers direct claims against the banks rather than only against the homeowners. The world has benefitted from this stability.

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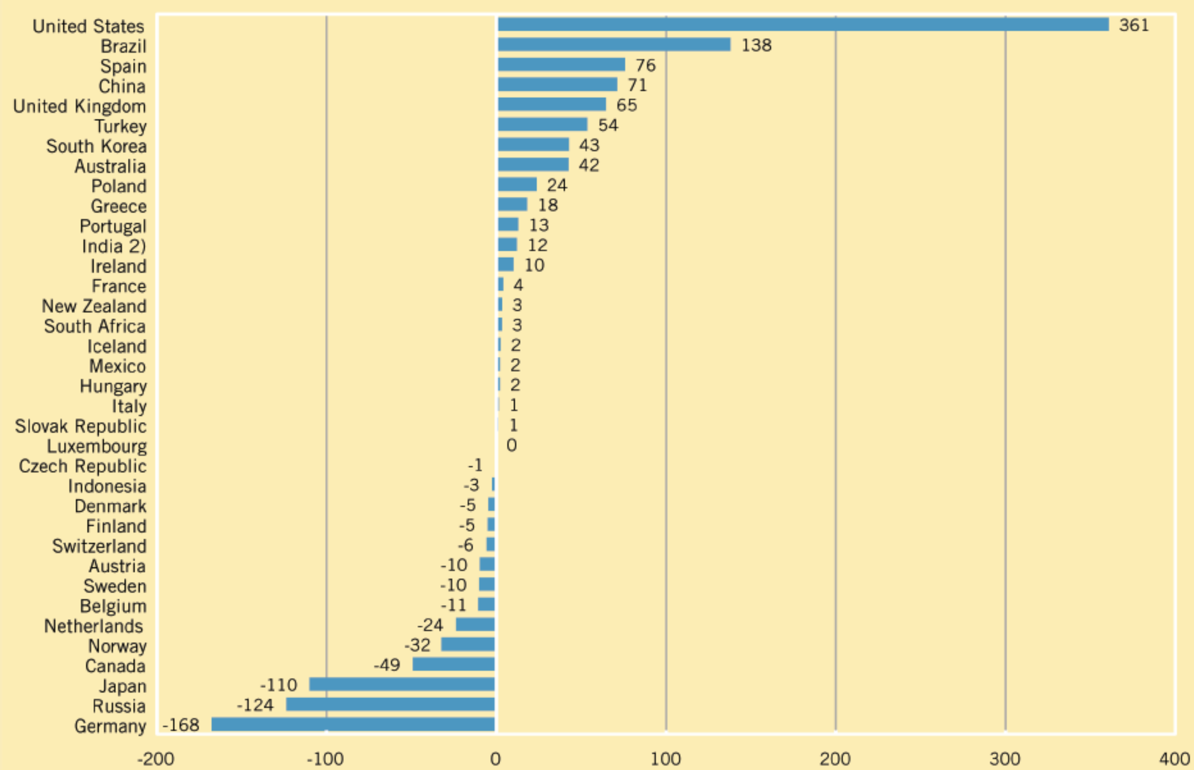
FIGURE 2: CHANGE IN ANNUALIZED TRADE BALANCES[1)], FROM Q1 2008 TO Q1 2009, IN BILLION US DOLLARS[2)]



1) Trade in goods, seasonally adjusted and annualized figures. 2) January and February 2009 against January and February 2008.
Source: OECD; calculations by the Ifo Institute.