The great recession - World Economic History Part 8

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– V.Srinivas IAS –

In 2008 severe recession unfolded in the United States and Europe which was the deepest slump in the world economy since 1930 and first annual contraction since the postwar period. The financial crisis which erupted in 2007 with the US sub-prime crisis deepened and entered a tumultuous phase by 2008. The impact was felt across the global financial system including in emerging markets. The 2008 deterioration of global economic performance followed years of sustained expansion built on the increasing integration of emerging and developing economies into the global economy. Lax regulatory and macroeconomic policies contributed to a buildup in imbalances across financial, housing and commodity markets. The international financial system was devastated.

The United States GDP fell by nearly 4 percent in the 4th quarter of 2008 with the broadest of US market indices, the S&P500 down by 45 percent from its 2007 high. World GDP growth slowed down from 5 percent in 2007 to 3 ¾ percent in 2008 and 2 percent in 2009. The IMF estimated the loan losses for global financial institutions at US $ 1.5 trillion. The Lehman Brothers collapsed in September 2008. The credit freeze brought the global financial system to the brink of a collapse. Weakening global demand depressed commodity prices. Oil prices declined by over 50 percent as also food and other commodity prices. Emerging equity markets lost about a third of their value in local currency terms and more than 40percent of their value in US dollar terms. Comprehensive policy actions were implemented to address the root causes of the financial crisis and to support demand. Faced with an imminent meltdown, the US Federal Reserve and the European Central Bank injected US $ 2.5 trillion into the credit markets. The United States passed an economic stimulus legislation to use public funds to purchase troubled assets from banks and several European countries implemented stimulus packages to manage the financial damage.

Policymakers around the world faced the daunting challenge of stabilizing financial conditions while simultaneously nursing their economies through a period of slower growth and containing inflation. Multilateral efforts were particularly important. During this period, China's geopolitical standing enhanced significantly. As the G8 member countries grappled with the crisis, it was important that given its mandate and wealth China had to be included in the discussions. The G20 framework representing 19 of the world's largest economies and the European Union became the coordinating body for handling the global crisis. The policy actions included programs to purchase distressed assets, use of public funds to recapitalize banks and provide comprehensive guarantees, and a coordinated reduction in policy rates by major central banks. Advanced economies as also emerging market economies witnessed moderation of inflation pressures due to rapidly slowing economic activity. There was scope for monetary easing and discretionary fiscal stimulus to support growth without undermining fiscal sustainability. Multilateral efforts were initiated to plug gaps in regulatory and supervisory infrastructure, fostering energy conservation and greater oil and food supplies, and enhanced efforts for unwinding the global imbalances. The effective appreciation of the renminbi and shifting resources of China and Middle East Oil Exporters to internal demand were pursued.

By October 2009, economic growth turned positive as wide ranging policy intervention supported demand and lowered the uncertainty of systemic risks to the financial system. Although the pace of recovery was slow, there was a rebound in commodity prices, pickup in manufacturing and a return of consumer confidence with firmer confidence in housing markets. The triggers for the rebound were strong public policies across the advanced economies and emerging market economies which supported demand and eliminated fears of a global depression. Central Banks reacted with exceptionally large rate cuts and Governments launched major fiscal stimulus programs. As the world economy ended 2009, the key policy challenge was to maintain supportive macroeconomic policies till the recovery was on firm footing. The withdrawal of the fiscal stimulus posed a risk in the near term, and the challenge was to map the timing of tightening of accommodative monetary policy conditions. The other policy challenge was to heal the financial sector while reforming the prudential framework. There were structural and social challenges of rising unemployment and poverty. Each of these challenges required international policy collaboration and cooperation which was achieved through the G20.

By April 2010, the world GDP growth was projected to rise to 4 ¼ percent based on highly accommodative monetary policies and supportive fiscal policies. The recovery had proceeded better than expected, and the world economy had reached a stage where monetary accommodation could be unwound cautiously with nominal exchange rate appreciation. Reform and repair of the financial sector remained a top priority for a number of advanced economies. This was taken up in the subsequent years.

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About the author

V.Srinivas IAS

Senior Bureaucrats and Author

V.Srinivas is an IAS officer of 1989 batch, presently posted as Chairman Board of Revenue for Rajasthan

He had previously served in the Ministry of Finance and as Advisor to Executive Director (India) IMF, Washington DC. Also worked as Planning and Finance Secretary of Rajasthan.