Arne Jon Isachsen
Seminar with SINOPEC
25 June 2010

HOW CHINA, USA AND EUROPE DEALT WITH THE FINANCIAL CRISIS

Han Suyin, Chinese novelist (1917-):

For me there are three types of human beings; Chinese, non-Chinese who have been in China, and all the others

1. The crisis is Made in America

The hubris of economists, cf. ”The Great Moderation”

William White (BIS) saw what was in the making, but nobody listened

Raghuram Rajan (IMF) warned of what might happen (2005), but was laughed off

1.1 Microeconomic base

Bill Clinton overdid it on housing: My home is my castle, although you cannot afford it

- Originator problem
- Financial innovations
- Rating agencies did a lousy job – were paid by the banks
- All risk is local

1.2 Macroeconomic base

Bill Clinton to Alan Greenspan: “I’ll run a tight ship, i.e. see to fiscal surpluses, and you run an expansionary monetary policy.” Worked remarkably well.

Bush/Greespan: Irresponsible fiscal policy; increasing expenditures while at the same time reducing taxes. For Greenspan, it seems, ideology overran his sound economic judgments.

“Greespan put” – reduce interest rates too willingly (Rajan: Excessive risk taking).

Avoid a recession at all costs (White: Better to clean up every now and then).

Bernanke (2005), *explained* what was happening, but did not *deal with it*.

1.3 China also played its part

Economic growth too much focused on exports and real investments, and too little on growth in private consumption (37 % of GDP, about twice as much for the US).

- For many years household income is growing less than GDP
- Financial repression
- Hard to have SOEs distribute profit to owner (MOF)
- Health, Education and Pension need to be more of a public responsibility

China needs a new model for economic growth
Which is in the making

- More flexible and gradually appreciating RMB versus the USD is a step in the right direction.

- However, increased domestic consumption is much more important.

1.4 The situation in the European Union (EU)

Euro area balanced trade with ROW. But unbalanced within.

- Germany, *low inflation*, accumulating claims on ROW (like China and Norway)

- Southern EMU-countries have *higher inflation rates* and spend more than they make, i.e. run trade deficits.

With same currency (euro) you have the same *nominal interest rate*

➡ What happens? *Real rates* very low indeed in euro-countries with higher inflation

➡ Consumption is booming, and residential construction in particular

It seems that the EMU-countries did not realize what it takes to have common currency with Germany. What, do you think, does it take?

2. How the crisis has been handled

16 September 2008: Lehman out of business

And the walls came tumbling down

2.1 The response of the US

TARP – Troubled Assets Relieve Program of 700 billion USD is enacted by Congress on October 3, 2008.
Buying up bad loans.

Change of direction – providing banks and financial companies with new equity, gives more bang for the buck.

Why not nationalize the banks, for a limited period of time, cf the Norwegian experience in the early 1990s?

- Semantic problem – to nationalize banks, or anything else, is not a good selling proposition in the US.

Owners and managers were treated too leniently

Obama enacted fiscal stimulus package of 787 billion USD

Economic growth very important to stabilize Debt/GDP

- Prognosis when Clinton left office:

  No government debt by 2010

- Prognosis now:

  From 40 % of GDP to 80 % within some ten years

Advantages USA: Population is growing, and labor market is relatively flexible

Disadvantages USA: Pension and Health expenditures on the rise, cf. baby boom generation getting old

Health expenditures (public and private):

USA:	16-17 % of GDP
China:	5-6 % of GDP
Europe:	8-9 % of GDP

2.2 China also is a fast mover

In November 2008 China announces a fiscal package of 4.000 billion yuan, over 27 months, i.e. through 2010

But mostly the stimuli are through increased bank lending

By April 2009 the amount of new loans from the banks equals the amount of new loans of the whole of 2008

Remember, five SOBs have sixty percent of the market

Local projects get finance, mostly infrastructure

- Roads
- Airfields
- Railways
- Urban developments
- Hospitals
- Schools
- Subways

Remember, the state owns all the land in China
The Chinese model, with lots of instruments under the control of the Government, seems well suited to handle the situation.

Replay of China's response to the Asian crisis 1997-99.

Problems down the road:

- Projects that do not generate enough money to service the debt
- Building up too much capacity (steel, auto)

China succeeds in maintaining economic growth of 8 % through 2009

2.3 Europe in dire straits

ECB follows the Fed and lower the interest rate quite rapidly

- UK advantage of a weaker GBP
- Sweden advantage of a weaker SEK. And negative interest rate in Riksbanken

Stability and Growth Pact is ignored (max deficit of 3 % of GDP on government budgets, came to be between 5 % and 13 %)

Government steps in with more money

- Save the banking system
- Contribute to aggregate demand
- But debt problems of banks become the debt problems of nations

Sovereign debts of Portugal, Italy, Greece and Spain (PIGS) increase beyond what seem sustainable

- Tensions within the EMU
- Germany bailing out lazy Greece?
- Could the EMU disintegrate?
- Or will EU move towards a political union?

3. Consequences of the crisis

The world is shaking

Redistribution of power?

3.1 No more going it alone for the US?

- President George W. Bush, in January 2002: “The course of this nation does not depend upon the decision by others”.

- Bill Clinton, more modestly; the USA as *the indispensible nation*. Probably still valid for decades to come

Barrack Obama has great challenges, to put it mildly

Easy way out on government finances:

Do as all the other OECD-countries, introduce *value added tax.*

Politically, not an easy sell. Economically, much to be said for

- Low rate
- Wide base
- Non-distorting
- Generates much money

USA – a declining power without realizing it?

Or – the come-back kid, as so many times before?

Remember the superiority of the Japanese model of the late 1980s?

3.2 China in the driver's seat?

China in many respects is still a developing country

800 million relatively poor peasants

Wen Jiabao: In fifty years, China will be a reasonably well-off society

Deng Xiaoping’s 24 characters:

Observe calmly; secure our position; cope with affairs calmly; hide our capacities and bide our time; be good at maintaining a low profile; and never claim leadership.

Coming to an end?
China asserting herself more powerfully?

China has been extremely clever in taking advantage of the international economic order. So far, a status quo power.

One thing for certain; the economic model has to change
Demand must increasingly come from domestic entities

Good news:

- Strike at Honda to increase pay
- Gradually appreciating the RMB
- More public funding for health, education and pension

Demanding issue: Will *hukou* disappear? And migrant labor become a category of the past?

3.3 Europe, getting her acts together?

Common currency a *political enterprise*. That was premature.

- Not similar preference for low inflation and stability
- Too little mobility in the labor market
- Consequences of common currency not well understood

Crisis of 2008 met with active fiscal policies.

But monetary policy not available, i.e Greece would very much have welcomed the opportunity to devalue her currency. But she does not have any.

Germany guaranteeing for Greek sovereign debt is against the rules of the game. Then, sometimes, the rules shall have to change

From monetary union, to fiscal union, to political union?

Will Europe finally realize that she will have to speak with one voice, if she wants to remain in the power game? Or may she as well exit the game?