SMART

Journal of Business Management Studies

(A Professional, Refereed, International and Indexed Journal)

Vol-15 Number-2 **July – December 2019** **Rs.500**

ISSN 0973-1598 (Print) **ISSN 2321-2012 (Online)**

Professor MURUGESAN SELVAM, M.Com, MBA, Ph.D, D.Litt
Founder - Publisher and Chief Editor

SCIENTIFIC MANAGEMENT AND ADVANCED RESEARCH TRUST (SMART)

TIRUCHIRAPPALLI (INDIA)
www.smartjournalbms.org

SMART JOURNAL OF BUSINESS MANAGEMENT STUDIES
(A Professional, Refereed, International and Indexed Journal)
www.smartjournalbms.org

DOI : 10.5958/2321-2012.2019.00010.1

GLOBAL ECONOMIC DOWNTURN: THE IMPACT OF FINANCIAL PRUDENCE

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Abstract

An attempt has been made in this paper, to gauge the magnitude, of financial crises during certain periods. Dwelling on the lessons, learned from financial interventions during the Great Depression of the 1030s, a few lessons were drawn with a view to avoiding future financial crises. Other financial crises, which triggered national and global economic downturns and financial interventions made during those periods, also dictated different lessons which were distinctly different from the lessons of the past, offering an array of financial interventions. The paper argues against over belief in market forces as they fail to ensure atomicity in creating desired results automatically. The paper also argues the case for strong market-based public activism and regulatory governance for ushering in financial and economic stability. The developmental State will need to put in place proactive regulatory framework, to guard against arbitrage and forbearance, in order to control financial market excesses which are often triggered by speculation and derivatives. This is indeed the panacea for ushering in the impact of financial prudence during the downturns of economies.

Keywords: *Depression, Financial crisis, Interventions, Market forces, Bailout, Financial prudence, Recovery, Financial market, Speculation, Derivatives*

JEL Code : *F02, F36 and F62*

Paper Received : 22-12-2018 ***Revised : 12-02-2019*** ***Accepte:21-03-2019***

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1. Introduction

The only lesson economists refuse to learn is the lesson itself. The lessons of intermittent global economic downturns, resultant adverse impact on the economies and of financial policy response and institutional directions, often fail to serve as guiding forces to prevent the repetition of past crises. Global economic downturns surface intermittently, stemming largely from new sources of crisis, demanding new solutions. During the Great Depression of the 1930s, Americans recovered their economy by spending, and the spending process continued all through. Their three programmatic policy accent was on spending, spending, and spending, while the Japanese priorities were on saving, saving and saving. The whole world was saving for the Americans to spend, making the USA the most indebted country in the world. Americans continue to consider spending as a potential source of wealth creation. Let us fast forward to bypass all other global economic downturns and look at the most recent global economic downturn triggered by the misbehavior of the private sector under the free play of market forces. We continue to bestow over belief on market forces, liberalization and deregulation despite learning bad lessons. During the recent crisis, all numbers became bad numbers, excepting two numbers: G20 and $ 1 trillion announced by G20 for bailout. It was tantamount to privatization of profit and socialization of losses.

Financial prudence, by way of selective interventions, to correct market failures, emerged as the panacea for recovering economies from economic downturns. Some call it market-based public activism to right the wrongs. The extent and effectiveness of such public activism hinge on how countries implement interventions, based on lessons learned from previous crisis. Finance is not merely prone to crises but its lessons could shape the future financial systems. The past crises demonstrate how the facets of current financial systems originated, based on lessons learned in the past, and prudent financial regulators dwell on those lessons as guiding forces. A well tuned financial system, will help converting savings into savers' surplus income in the future, making borrowers earn more now. When savings are converted into sources of earning for borrowers, a prudent financial system will prevent speculators from making economies plunge into sharp downturns. Prudent financial system certainly acts as an engine to foster a healthy pace of economic expansion.

2. The Great Depression of the 1930s

Earlier literature by **Christiano, et al. (2003)** and **Friedman-Schwartz (1963),** on the Great Depression of the 1930s, point to contracting money supply, poorly regulated banks and inadequate monetary response as principal causes of economic downturn. When Franklin D. Roosevelt assumed office as the 32nd President of the US in 1933, in his inaugural address he said: "Only thing we have to fear is fear itself". He converted the US into a Keynesian laboratory to recover American economy from the Great Depression through government spending and interest rate and tax reductions, with a programmatic accent on pump priming. The term pump priming is derived from the operation of old pumps – by priming a suction valve with water so that the pump would function properly. This was the financial intervention made by Roosevelt's administration. **Christina D. Romer (2009)** draws a number of lessons from financial interventions to recover the American economy from the Great Depression of the 1930s. The summary of those interventions merits attention.

Lesson-(i): A small fiscal expansion has only small effects.

Lesson-(ii): Monetary expansion can help to heal an economy even when interest rates are near zero.

Lesson-(iii): Beware of cutting back on stimulus too soon.

Lesson-(iv): Financial recovery and real recovery go together.

Lesson-(v): Worldwide expansionary policy shares the burdens and the benefits of recovery.

Lesson-(vi): A key feature of the Great Depression was that it did eventually end.

There is always something good stemming from bad things. The above lessons learned from the financial interventions, to recover the American economy from the Great Depression serve as evidence-based policy advocacy towards public activism to right the wrongs during the downturns of economies. Among Keynesian prescriptions, spending was suggested as an economic virtue **(Vinanchiarachi Jebamalai, 2018).** Ever since the economy recovered from the Great Depression, Americans have been spending lavishly and endlessly within the framework of their own convincing rationality. With a debt in terms of trillions, exceeding the gross domestic product (GDP) of the country, which Americans owe to the whole world, the economy is poised to strengthen further as they spend borrowed money. The implication is clear. A nation cannot grow unless the people spend. Spending is good. Is the American way of spending borrowed money good? Do those who fail to spend wastefully save? Does American experience tells us that fools save and only the wise people spend?. It is worth reflecting on possible answers to those questions within the framework of economic reasoning and rationality. Unfortunately, it is being increasingly proved that consumers and producers no longer act rationally. The trend questions the fundamental assumptions of economic theories.

Richard H. Thaler (2015), the 2017 Nobel Prize winner in Economics, talks about the consequences of limited rationality in individual's decision making. Thaler also talks about behavioral finance which makes an indelible impact on financial markets. Given those emerging trends, one wonders whether the lessons of financial interventions, made during the Great Depression, are immediately applicable policy actions in the new economic setting, which is being increasingly dominated by the absence of economic rationality in the actions of individuals and societies. Today, the Indian economy emerges as the world's fastest growing economy thanks to dramatic increase in consumer spending; bearing testimony to Keynes' conviction that spending is good. But consumer spending in India stands out because of a significant change in the pattern of spending triggered by a change in the behavior of Indian consumers, who tend to spend more on luxury items than on necessary items. The trend is triggered by a change in consumer spending pattern and not necessarily underpinned by economic reasoning.

3. The Indian Economic Crisis of the Early 1990s

The Indian economy virtually collapsed in 1991. The initiatives of Dr. Manmohan Singh, the then Finance Minister, to save the economy from near-bankruptcy was a historic achievement of India. The way he used the black money as a source of addressing the financial crisis was worthy of appreciation. The way he mobilized the money through special incentives to the Non-Resident Indians (NRIs) was doubly effective and appropriate. Again, the crisis turned out to be beneficial in opening a new era of liberalization, which created competitive pressure for efficiency gains. The Indian automobile sector is the best example. For decades, the country's domestic market potential was allowed to be exploited by two car makers. Thanks to liberalization, now there are several Indian-made foreign cars on the roads. Liberalization enabled the car producers to establish links with the dynamic sources of growth. It also enabled them to leverage domestic skills and knowledge with those dynamic sources of growth and thereby enabled the Indian producers to learn and innovate. As a result, a 100 per cent indigenous car of world-class **"Tata Indica"** emerged from the production line. **Rodrik** and **Subramanian (2004)** noted that the reforms of the early 1980s were somewhat subtle and that the reforms of 1990s were much more radical and far reaching, making a breakthrough in the policy space and institutional direction.

4. The East Asian Financial Crisis of the Late 1990s

In the 1980s, there was a mad mania for appreciating all that happened in the Newly Industrializing Countries (NICs) of East Asia in general and the Republic of Korea and Taiwan Province of China in particular. For economists, all that happened in those two NICs was good and everything else elsewhere was bad. In 1986, I registered my name for doing Ph.D. under Dr. K. Rajaratnam, Director, Centre for Research on New International Economic Order, Chennai, India. My guide was fascinated when I told him about my decision to do my research on the East Asian Model of development, with a view to making an inquiry into the viable avenues of replicating the East Asian Model in India. During the course of my research, I realized that there was certainly something fundamentally wrong with the development pattern since it fuelled structural, financial, physical and cyclical vulnerabilities, stemming from the high import intensity of export orientation, being funded by short-term lenders. I realized that everything would collapse the day the short-term lenders decided to withdraw lending. The highly import-intensive export orientation, fostered with the aid of short-term lenders, was a source of a number of vulnerabilities, leading to financial distress. The East Asian crisis is a good case study, for analyzing the extent of distress and closure of financial institutions **(Paola Bongini, et al, 2001).**

When the East Asian financial crisis occurred in 1997, ten years after my research, my guide, Dr. K. Rajaratnam, called me to say that what we had partly predicted, did happen. He suggested that we should publish the thesis. The original title *Dependent vulnerability of manufactured exports of East Asian NICs: An inquiry into the viability of replicating the East Asian model of development in India,* was changed into *East Asian model of development: Lessons for India,* as the title of the book. The book was released by late Mr. Murasoli Maran, the then Minister for Commerce and Industry, Government of India, a trusted friend of mine, at a grand function in Chennai. When I questioned the East Asian model of development, my critics criticized me, saying that my approach was hundred percent wrong. In the light of the East Asian financial crisis, the same critics said that I was 101 per cent right.

5. Global Financial Crisis of the Late-2000s

No one predicted the crisis. The crisis stemmed from the fact that the private sector misbehaved. The downturn, that started in 2007, was amplified by the bankruptcy of Lehman Brothers, in September, 2008. The downturn was distinct from normal cyclical downturns because the crisis surfaced suddenly and unexpectedly and it was triggered and exacerbated by a disruption in the financial sector, with the key event being the bankruptcy of Lehman Brothers **(Eichengreen, 2009** and **Zingales, 2008)**. Speculations went beyond limits and the exaggerated imagination about the sustainability of the property bubble resulted in the crisis which spread across countries, affecting the entire global economy. During the crisis, all numbers turned out to be bad, including the G20 and $1 trillion announced by the G20 nations to bail out the companies which were strangled in the clutches of the crisis. The decision of G20 implied that globalization was basically privatization of profit and socialization of losses. When private enterprises could earn profit, they were allowed to enjoy it. When they faced losses, they were bailed out.

The resilience was more due to limited integration of the economy into the global economy and the strong domestic demand than to its strength. A number of Least Developed Countries (LDCs) such as Benin, Niger and Swaziland were not affected because of their lack of integration into the global economy. Bhutan was not affected severely as whatever happened elsewhere, was not immediately transmitted into the economy. Bhutan follows a different concept of development with its own definition of Gross Domestic Happiness. As it does not want the tourists to affect the sanctity and serenity of the country, it even imposes annual restrictions on the number of tourists to be allowed to visit the country. For my doctoral degree in Economics, I tried to understand the extent to which growth in manufacturing output was foreign in origin in India, using the method first presented by **Hollis B. Chenery (1975**) and **Vinanchiarachi Jebamalai (2000).** The basic tenets of Chenery's formula were used, with a view to estimating the "sources" of growth in the sub-sectors of manufacturing, by decomposing the sources of growth into:

(a) growth in domestic demand;

(b) growth in external demand;

(c) growth in import substitution.

The results indicated that domestic demand accounted for over 96 percent of increase in manufacturing in India. Since domestic demand continues to play a predominant role, the Indian economy continues to demonstrate a high degree of resilience during the cyclical downturns of the global economy. Revisiting the domestic demand potential as the principal source of sustainable growth and prosperity, is critical. The difference between the two global economic downturns in the 1930s and 2000s is evident in the approach adopted to stimulate recovery. During the Great Depression of the 1930s, interventions were attuned to stimulating consumption and investment. To stimulate economic recovery, we now focus on investing in R&D and innovation-related programmes. So far, G20 governments have announced more than $200 billion in new innovation programmes, in addition to the huge sum earmarked for the bailout. True globalization should promote the survival of the fittest, and losers perish. A part of the money earmarked for bailing out was destined for strengthening the role of R&D and innovation in the current transformative shift from a quantitative increase to the qualitative improvements. Never should we allow a crisis to go waste. We observe often the confluence of resurgent interest in industrial policymaking and climate change agenda. The current crisis is increasingly being seen as an opportunity to encourage real **"green shoots"**. Special funding for research, education, energy, green-tech investments and innovation constitute a major part.

A number of middle income countries get stuck on the ladder of value addition due largely to their failure to strengthen national and sectoral innovation systems. As a result, they failed to keep pace with the rapidly changing facets of processing, design and marketing in an internationally competitive environment. Amidst determined efforts to stimulate global recovery, one should not forget the poor and the potential to break in and move up. In 1911, the famous economist, Joseph Schumpeter, argued that the services provided by financial intermediaries were essential for technological innovation and economic development. Those services included mobilizing savings, evaluating projects, managing risk, monitoring managers and facilitating transactions. As financial governance did not keep pace with the pace of the so-called financial innovation in recent years, mistakes of imaginary wealth creation resulted in the global economic downturn of the 2000s. The crisis made us rethink about the realities in development. The current priority accent is on innovation, and substantive resources are being committed to stimulate innovation. Stimulating industrial innovation during a downturn is indeed a challenge and an opportunity. The challenge is to ensure good governance of financial intermediaries and the opportunity stems from the way we seize opportunities from greening industry. What the global economic crisis has done is to confront governments worldwide with stark strategic choices. Information asymmetries and coordination failures have been exacerbated by the international nature of the crisis, making decision-making more difficult, but choices must be made and are being made as the productive structure of the world is experiencing radical transformation. Strategic industrial policy in this context is about identifying the opportunities of the changing world and domestic landscape, providing for the establishment of new manufacturing activities. We all should be at it today, for tomorrow may be too late.

6. Conclusion

There is no atomicity in market forces. The private sector will always misbehave under laissez faire as evident by the misbehavior of a few, triggering global economic downturn in recent years. Over belief on liberalization, deregulation and market forces should end and regulatory governance should govern to right the wrongs of the private sector in the financial market. Selective interventions to stabilize financial markets and economies are pivotal. The developmental State's interventionist efforts should be considered as regulatory growth impulses to avert the bad effects of speculation and derivatives. The theory of regulation may not furnish a body of settled conclusions immediately applicable to policy interventions in the light of behavioral economics, which is increasingly being outside the realm of economic reasoning and rationale. It is not the question of lack of regulation but lack of effective implementation of regulatory norms often paving the way for global economic downturns. The developmental State will need to put in place proactive regulatory framework to guard against arbitrage and forbearance in order to control financial market excesses. This is indeed the panacea for ushering in the impact of financial prudence during the downturns of economies.

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