Welcome to the…

Dialogue on

The Global Financial Crisis and What it Means for Bangladesh

CIRDAP Auditorium

Dhaka; 25 October 2008

CENTRE FOR POLICY DIALOGUE (CPD)
B A N G L A D E S H
a civil society think – tank

THE ONGOING GLOBAL FINANCIAL MELTDOWN AND LESSONS FOR BANGLADESH

Presentation by

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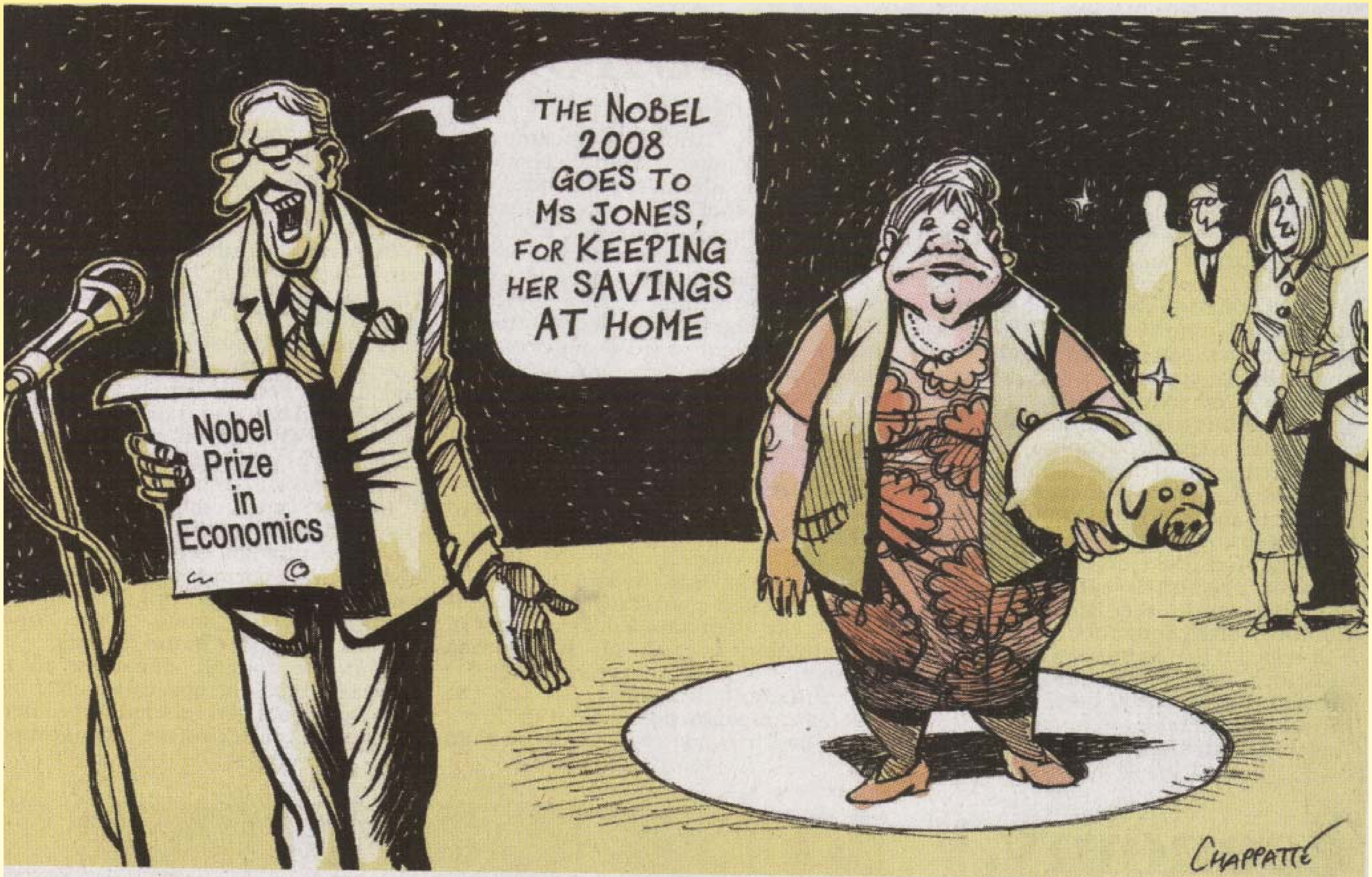
The presentation builds on THREE ASPECTS of the problematic

1. DIAGONISTICS
2. EFFECTS
3. RESPONSES

and

A set of afterthoughts on LESSONS FOR BANGLADESH

But before all that – Meet MRS. JONES



By Chappatte in Le Temps (Geneva). Globe Cartoon

I. The Financial Meltdown: A Diagnostics

First: Why did the current financial crisis become a global one?

- US financial institutions forwarded bad mortgages to foreign banks, foreign banks eventually confronted deteriorating balance sheets.
- Financial crisis caused an economic slowdown for US economy → decreased US demand for foreign goods + decline in demand due to fall in dollar.
- Persistence of global economic imbalances exacerbates negative effects of the financial crisis on the real economy.
- ➤ Large current account deficit mirrored by large current account surplus of China.
- ➤ Falling demand by the US is yet to be balanced by an increasing demand of surplus economies.

I. The Financial Meltdown: A Diagnostics

Second: Could we have seen the crisis coming?

- International financial institutions, particularly IMF have failed to foresee and prevent outbreak of major financial crisis, and thus was unable to service its mandate.
- The Financial Stability Forum – founded following the Asian financial crisis to detect onset of financial instability - failed to fulfill its objective.

Whey did they fail? Because:

i. They have a strong belief in the self correcting mechanisms of the market, they are blind to market failures, and reluctant about stronger market regulation

ii. They focused on reforming markets in debtor (developing) countries, but was oblivious about transparency and reform in the financial markets of creditor (developed) countries

Result: They failed to detect difficulties associated with US housing market

I. The Financial Meltdown: A Diagnostics

Third: Did we have early warning signals?

- Critical macroeconomic literature has repeatedly stated that there must be something wrong with a financial market that ends up in crisis every five year.
- ➤ Beyond general warning it was difficult to detect the current financial crisis as financial instruments lacked transparency.
- In 2006 – tip of the iceberg emerged: Between 2004/2006, US interest rate rose from 1% to 5.35% → housing market began to suffer → prices falling and rise in defaulting mortgages → default on sub-prime loans reaches record level.
- In April 2007, sub-prime loan crisis become evident → estimated losses between $50 billion to $100 billion.
- New Century Financial filed for Chapter 11, but it infected debt-purchasing banks around the world. For instance, Bear Stearns.

I. The Financial Meltdown: A Diagnostics

Fourth: Could the crisis have been as severe if it had not coincided with other crises, especially rise of commodity prices?

- Rising commodity prices hardly affected the magnitude of the financial crisis, but definitely impeded its effective resolution.
- Upward pressure on producer/consumer prices has prompted many central banks to tighten monetary policy to avoid inflation.
- It was hasty and counter-productive for investment and real economy.

I. The Financial Meltdown: A Diagnostics

Fifth: Was the crisis encouraged by a lack of liquidity, solvency and/or confidence?

- What emerged in 2007 as an apparent LIQUIDITY PROBLEM in an obscure corner of a sophisticated, highly leveraged and apparently risk-free financial market has acquired a dimension beyond any pessimistic prognosis.
- Weakness of the US housing sector is being gradually exposed as not only LIQUIDITY PROBLEM of the US financial markets, but also emerged as SOLVENCY PROBLEM of banks and financial enterprises internationally (threatening, in some cases, solvency of national economies).
- The crisis continues to be reinforced by a lack of CONFIDENCE and TRUST. It is upto the rescue packages to restore market confidence and trust among banks and revive inter-bank lending and to increase lending to private sector.

I. The Financial Meltdown: A Diagnostics

Sixth: Was the problem created by weak regulation and oversight? At national or international level?

- The principal factor that has encouraged the current (as well as previous) financial crisis is the attempt of the financial investors to make double-digit profits (CASINO MENTALITY!). Although most enterprises in real economy tends to have single-digit profit. *It is not possible for all financial investors to outperform the economy at all times.*
- In full speculative swing, uniformity of behaviour of all market participants (HERD MENTALITY!) creates manias and panics. If expectations are not corrected in a timely fashion, it results in bubbles and burst, seriously affecting real economy. We are currently witnessing the “Mother of all bubbles and busts”.
- Complexity of financial instruments, and associated lack of transparency, has prevented timely corrections of expectations.

I. The Financial Meltdown: A Diagnostics

- By not spreading the risk in a transparent way, market operators chose ways to "securitize" risky assets. Credit rating agencies failed to understand these products. As they were rarely traded, approximate value of these structured financial products was not known.
- Today's financial crisis has been facilitated by the RELUCTANCE of countries as well as international financial institutions to better regulate and monitor financial markets. It was based on irrational competency with recent GLOBAL ECONOMIC TRENDS and FREE MARKET ENGINEERING.

Outcome: A trillion dollar (non) worth of "toxic waste" handed down to the tax-payers!

I. The Financial Meltdown: A Diagnostics

II. The Financial Meltdown: Tracking the Effects

First: What is the likely effect of the global financial crisis?

- The current crisis represents the largest financial shock since the Great Depression. It has the potential to trigger a DEEP GLOBAL RECESSION if counter-cyclical policies are not applied in a coordinated fashion. But considerable UNCERTAINITY remain as to its extent and scale as well as effect on real economy.
- But the following are expected to happen:

⇨ Deleveraging of securitized financial instruments will start affecting "non-high risk assets" leading to <u>liquidity problem.</u>

⇨ <u>Credit crunch</u> is imminent if bailout packages fail to absorb all bad loans and restore sound balance sheets.

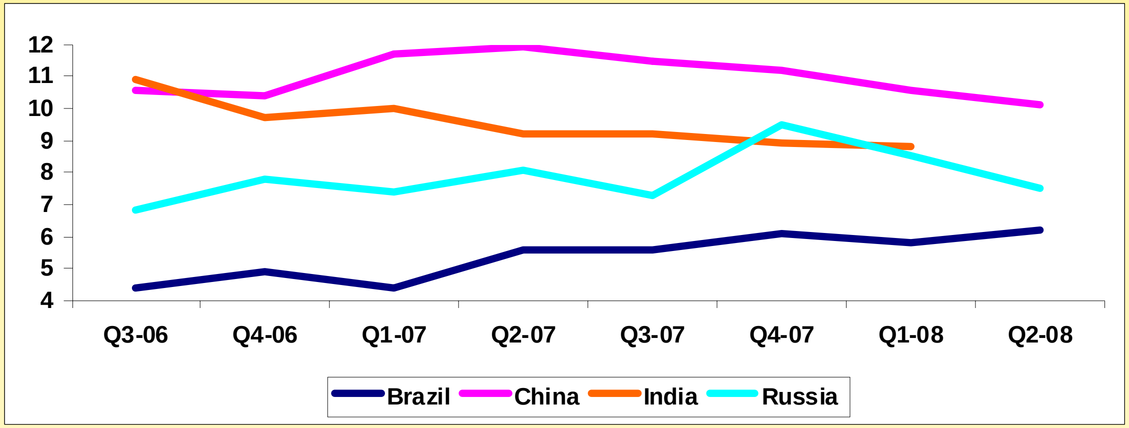
⇨ If revival of real economy is delayed, <u>financial costs of bailouts</u> will continue to increase

⇨ End of the period of Great Moderation causing steep slowdown, if not worst recession in advanced economics.

⇨ IMF WEO 2008 predicts on average a zero nominal growth rate in G7 countries.

II. The Financial Meltdown: Tracking the Effects

Quarterly GDP growth rates, selected countries, annual percentage change, 2006–2008



Source: Economist Intelligence Unit and IBGE.

GDP growth rates, selected country groups, 2006–2009

	2005	2006	2007	2008
CIS	6.8	7.7	8.6	7.6
Africa	5.7	5.6	5.8	6.0
East Asia	7.5	7.9	8.1	7.2
South Asia	7.7	8.2	8.5	7.0
South-East Asia	5.7	6.0	6.4	5.4
West Asia	6.8	5.7	5.1	5.7
Latin America and the Caribbean	4.9	5.6	5.7	4.6
Developing countries	6.6	7.1	7.3	6.4
Developed countries	2.4	2.8	2.5	1.6

Source: TDR 2008, table 1.1.

II. The Financial Meltdown: Tracking the Effects

- Developing countries get affected by:

⇨ Reduced world demand for their products

⇨ Diminished demand for their services and fall in remittances

⇨ Increased cost of borrowing through higher spreads and higher risks for rollover of existing government debts.

⇨ Potential drop in ODA

The question is not WHETHER, but rather WHEN and HOW the developing countries will be hit by the crisis emanating from the advanced economies.

II. The Financial Meltdown: Tracking the Effects

Second: What is the nature of the THREE CHANNELS of likely effects?

- Trade
- Private capital flows
- Official development assistance

All three are relevant for BANGLADESH! Bangladesh as a "Small" open economy is more prone to external shocks in comparison to bigger and more diversified economies.

II. The Financial Meltdown: Tracking the Effects

- **TRADE:**

i. Deterioration of foreign exchange earnings due to slowdown in advanced economies.

ii. Increased cost of financing affecting supply-side expansion.

iii. Countries like Bangladesh with high share of manufactures in its export basket will more readily affected than commodity-exporting developing countries. But will also depend on –

(a) Income elasticity of demand for exports

(b) Extent of "decoupling" from traditional (crisis-stricken) export markets.

II. The Financial Meltdown: Tracking the Effects

- **PRIVATE FLOWS**: Global FDI peaked in 2007 and is forecasted to decline, but will remain relatively stable. Uncertainties and reduced business confidence will be moderated by:

i. A number of private equity funds (PEFs) have been established in developing countries, but as they rely heavily on debt financing are likely to reduce investment in short term.

ii. Sovereign Wealth Funds (SWFs) increasingly investing through FDI (including Greenfield FDI), in some cases, in developing countries. They will not get affected in short run.

II. The Financial Meltdown: Tracking the Effects

iii. Developed countries TNCs (MNCs) may continue to invest based on retained earnings. But they may engage in repatriation of a large share of their profits.

iv. Southern TNCs (MNCs) also largely invest based on profits which is high at this moment, but may decline if crisis is protracted.

v. Remittances from expatriate workers may fall as demand for imported labour declines along with recession in advanced economies. But sources of Bangladesh's remittances are "decoupled" from developed economies.

II. The Financial Meltdown: Tracking the Effects

- Official Development Assistance (ODA): The net ODA decline in 2006/07 already poses a large risk for MDG achievement.
- Tension in preparing 2009 budgets of donor governments and possible crowding out of resources for ODA.

⇨ Strict fiscal deficit limits will potentially need to reschedule their aid flows

⇨ Lagged response of fall in ODA disbursement is probable with increase during crisis period (particularly grant disbursement)

- No immediate sharp decline in aid flow due to its stickiness, but prolonged slowdown in donor countries will affect ODA disbursement.

II. The Financial Meltdown: Tracking the Effects

Third: What are possible effects on different country groups and regions?

- The effects will vary substantially across the globe depending on size and structure of the national economy, as well as level and nature of global integration (including exposure to financial market upheaval).

USA: Continues to decline in final quarter of 2008 and first quarter of 2009, stabilizes in second quarter of 2009 and then start progressive recovery.

Euro Area: Growth to fall from 2.6% (2007) to 1.3% (2008) to 0.2% (2009), before returning to 1.4% (2010)

II. The Financial Meltdown: Tracking the Effects

China: So far thought to be relevant to the crisis, new figures show that demand for labour slowing down reflecting relaxed exports. But overall domestic demand growth and investment activity steady.

Other emerging economies in Asia: Slowdown of growth from 9.25% (2007) to 7.75% (2008) to 7% (2009). Consumption will be lower affected by still-high prices of fuel and food.

Africa: Effects to be determined by evolution of commodity prices. Cushion provided by China and India may not last. While commodity prices are expected to remain above historic levels and volatile, but sharp decline is not excluded. But large disparity between oil-exporting and non-oil exporting countries.

Latin America: Impact to be determined by interplay of several factors given their relatively advanced financial integration and relatively diversified export composition.

II. The Financial Meltdown: Tracking the Effects

Fourth: How can developing countries reduce their exposure to global economic meltdown?

- The full effects of financial crisis on developing countries have not yet been registered. Lack of real time data is a problem.
- Factors contributing to relative resilience of developing economies to the global financial:

i. Domestic demand has assured a more important role in growth

ii. Increase in primary commodity prices has strengthened the external account and reduced dependence on foreign capital

iii. Maintaining a competitive real exchange rate through exchange rate management

II. The Financial Meltdown: Tracking the Effects

Fifth: Are these factors true for BANGLADESH ?

- Slowdown in past 12 months, but remain strong by historic standards. “Decoupling” taking place”?
- West Asia and Africa as well as CIS felt little adverse effects, East & South Asia and Latin America, Caribbean and Central & Eastern Europe more affected.
- LDCs are to be affected more, but given the trade relationship.

II. The Financial Meltdown: Tracking the Effects

Sixth: Is “decoupling” feasible and meaningful for low income countries?

- Evidence to date shows that emerging market economies were able to decouple their business cycles from advanced economies, even though they are more interlinked today in comparison to 1990s.
- But recent slumps in stock market in emerging economies (also in Bangladesh?) are a clear signal that there is a some dichotomy between the real and financial sector, or at least a time-lag between the two sets of effects. The prospect of continuous confidence crisis in advanced markets economies might affect financial sectors in emerging markets.

II. The Financial Meltdown: Tracking the Effects

- The risks for low-income countries are rather different and severe. Their real economy decoupling has never been strong.

⇨ Large external demand shocks will immediately have real economy impact as they can not be cushioned by internal demand.

⇨ Financial sectors are weak and shallow, thus will not be able to accommodate large external shocks and substantial increase in borrowing costs.

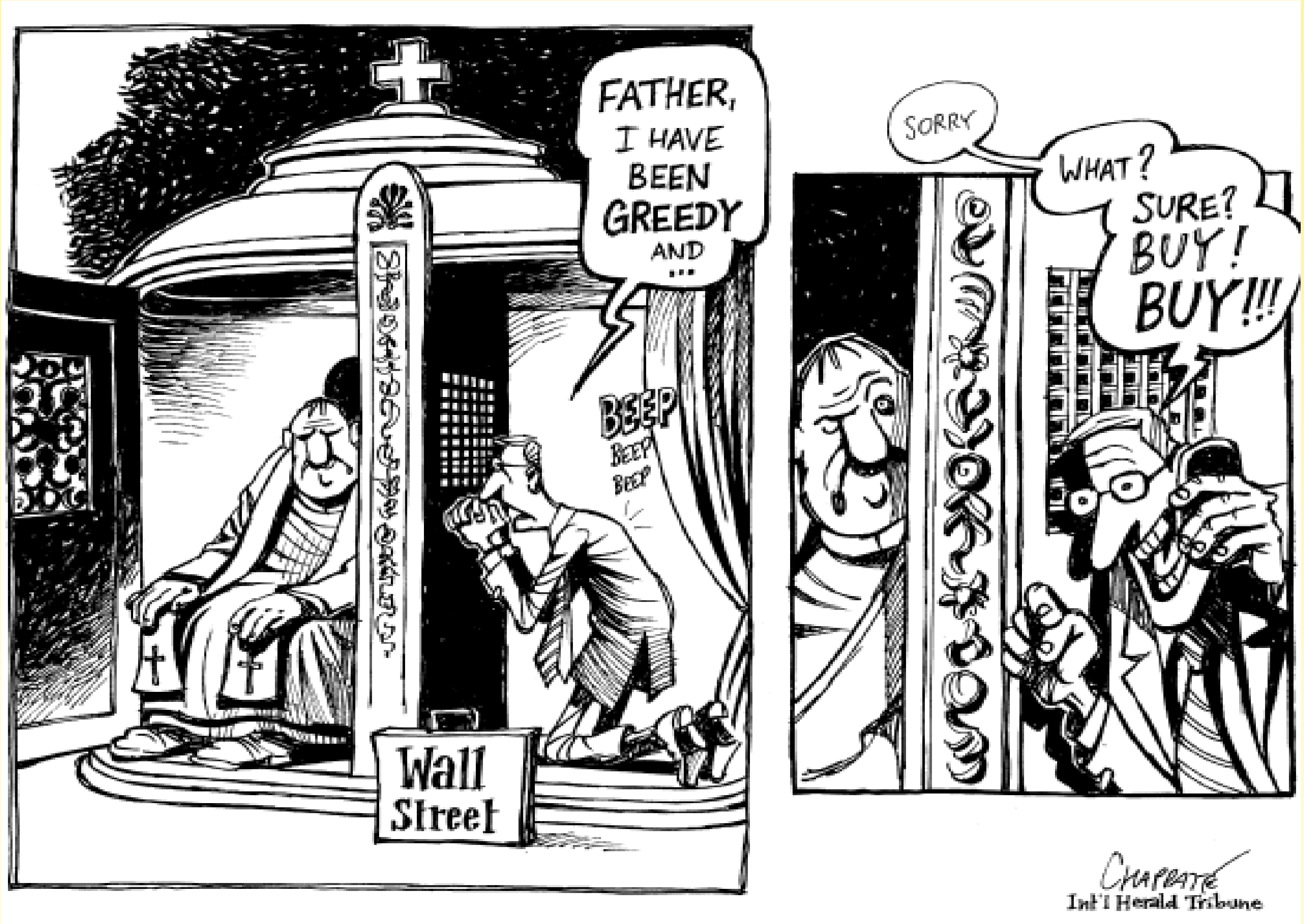
⇨ Global boom of commodity prices has come to halt.

⇨ Detrimental effects in ODA may accelerate economic slowdown in LDCs.

How relevant are these prospect for BANGLADESH?

Decoupling from advanced economies not feasible, but reorientation to emerging economies is meaningful.

II. The Financial Meltdown: Tracking the Effects



III. The Financial Meltdown: Cataloging the Responses

First: Were there any general pattern in responses?

- Governments across the world have taken multiple efforts to mitigate impact of financial crisis in mainly four areas:

i. Liquidity:

(a) Increasing short and medium–term liquidity in inter-bank markets, largely through central banks' direct involvement in refinancing operations of commercial banks .

(b) Granting government guarantees to inter-bank operations to reduce counterpart risks.

(c) Governments establish and widen deposit insurance schemes to avoid bank run.

III. The Financial Meltdown: Cataloging the Responses

ii. Solvency:

(d) Governments are increasingly willing to inject capital directly into corporations thereby facilitating bank restructuring programme in the face of solvency crisis.

(e) Governments commit to buy bad assets to ease financial restructuring of banks' balance sheets.

iii. Confidence and Trust: Overtures and gestures (across regions) of political leaders and market regulators to restore market confidence.

III. The financial Meltdown: Cataloging the Responses

Second: What are the differences between EU and US rescue packages?

- In one way or other, the US and European countries, led by the so-called "British Model" ala Gordon Brown, have agreed to tackle the problems of liquidity, solvency and confidence in various ways – one being more comprehensive than other with diverging emphasis.

United States:

- The Emergency Economic Stabilization Act (3 October 2008) puts more emphasis on purchase of distressed assets-buying $700 billion worth of package.
- Federal Reserve to provide liquidity to the inter-bank market – which remained paralyzed in fear of counter post risk. Fed was an integral part of global rate cut (3 October 2008) involving 7 major central banks of the world.

III. The financial Meltdown: Cataloging the Responses

European Countries:

- On 12 October 2008, agreed to follow the British model of financial rescue by way of (i) liquidity provisioning through central banks and state guarantees for inter-bank operations and deposit insurances, (ii) capital injections to restructure financial institutions.

⇨ As may be seen, purchase of "toxic assets" not the focus here, rather it is on liquidity injection. US has later added on the provision of capital injection to distressed banks (14 October 2008)

⇨ As elsewhere no "system-relevant" bank will be allowed to fail, no depositor will lose money. At the end of 2009, the life support system is to be switched off.

III. The financial Meltdown: Cataloging the Responses

Third: What are the responses in emerging economies?

- **Brazil** – Trying to stabilize currency (Real). Sao Paulo stock Exchange suspended trading on occasions in one week.
- **China** – Joined the rate cut offensive. Second such cut in 3 weeks.
- **India** – Unexpectedly cut its key interest rates (20 October) by one percentage point – from 9% to 8%.
- **Mexico** – Selling reserve to prop up national currency (Peso). Proposed $4.4 billion package to boost economy.

III. The financial Meltdown: Cataloging the Responses

Fourth: Any regional response by developing countries?

Asia:

- Chiang Mai (self-help) initiative of post-Asian crisis (1997/98) reinforced by ASEAN+3 (China, Japan and ROK) will have a meeting on 24-25 October 2008 in Beijing.
- Asian Crisis Fund hampered as World Bank is not ready to contribute a claim of 10 billion. Implementation of an earlier decided currency sways Scheme of #80 billion is being accelerated.

Latin America:

- Inter-American Development Bank (IDB) approved record volume of loans.
- Setting up fast disbursing $6 billion liquidity facility
- More liquidity facility from Canadian Development Corporation (CDF) - $1.5 billion and Latin American Fund of Reserve (FLAR) - $1.8 billion

III. The financial Meltdown: Cataloging the Responses

Fifth: What are appropriate responses at international level?

- For discouraging financial speculation, countries need better coordination of economic policies including rules and regulations governing the monetary and exchange rate policies.

⇨ NEED TO HAVE A FULL-FLEDGED MONETARY AND FINANCIAL SYSTEM – The idea of cooperative global monetary system is as compelling as the idea of a multilateral trading system.

⇨ Exchange rate deviations create externalities and multilateral repercussions as is done by tariff and export subsidies. Thus, we need to promote a system with a code of conduct for ….. of XR system – will discourage competitive devaluation as well as of large global economic imbalances.

III. The financial Meltdown: Cataloging the Responses

- ⇨ IN THE ABSENCE OF STRONGER ECONOMIC POLICIES, COUNTRIES TO DEPLY OTHER TOOLS AS SECOND BEST. For Example, capital controls and other economic policies to discourage financial speculations as well as reduction in exposure to financial crisis.
- ⇨ NEED FOR GLOBALLY COORDINATED MEASURES TO IMPROVE SYSTEMATIC IMPACT OF NATIONAL POLICY MEASURES.
- Temporary fiscal support to stimulate economy and avoid recession
- Provision of liquidity to avoid credit crunch
- Facilitate an orderly unwinding of global imbalances – rebalancing of domestic demand with supportive exchange rate
- Tighten up regulations to deal with such financial innovations as securitization and off-balance-sheet financing.

III. The financial Meltdown: Cataloging the Responses

Sixth: Is the Bush initiative going to meet the demand for multilateral cooperation and coordination?

The Current Initiative

- Bush-Sarkozy-Barroso meeting on 18 October proposed a series of global meeting to deal with the financial crisis.
- Secretary General Ban Ki-moon backed the idea and proposed to hold in New York.
- President Bush has now settled for 15 November in Washington DC.

Scope of the Initiative

- Mr. Bush takes a rather restricted view regarding modernization of the international financial. He does not see the need for taking a systemic scrutiny about the role of state and markets.

III. The financial Meltdown: Cataloging the Responses

- Mr. Sarkozy seems to have a broader vision. He maintains that inter alia, hedge funds, tax have and financial institutions operating without supervision should be re-thought.
- Whatsoever, the current approach remains limited in terms of its scope as fundamental systemic concerns are yet to be recognized upfront. Moreover, as experience with G7+ shows that participation of emerging and marginal stakeholders are limited. No poor country among the new G20!

Another Bretton Wood?

- Indeed, the current financial crisis has exposed the entrenched theoretical and operational fault-lines of the BrettonWood approach. There would be also serious conflict of interest in having either a US/EU lead initiative of IMF/WB guided process. The new multilateralism will find a more conducive incubator with a UN-promoted effort.

III. The financial Meltdown: Cataloging the Responses

P.S. Almost Forgot – The Golden Parachute for CEOs!

The former CEO of the bankrupt Lehman Brothers, Richard Fold became the porter boy for Wall Street greed today as he defended the $484 million he received in salary, bonuses and stock option since 2000.

That is $5 million per month for running the company to bankruptcy!

Four days before the firm filed for bankruptcy, Fold recommend that the board give three departing executives over $20 million in "Special Payment".

IV. The Financial Meltdown: Implications for Bangladesh

First: Do we know how Bangladesh will be affected?

- It is too early to conclusively assess the impact on Bangladesh as the global financial crisis continues to rage across the world.
- We are yet to know the width/depth, latitude/longitude of the crisis.
- We do not have fuller understanding of the transmission mechanism.
- We do not have the real time data to assess the situation.

Yet applying our analytical techniques on the existing knowledge base, it can be deduced that in the global spectrum Bangladesh lies somewhere between the emerging economies and the low income (non-oil exporting) countries. So it will have a mix of the possible impacts of the both sets of countries.

IV. The Financial Meltdown: Implications for Bangladesh

- It will be not immune from the negative spillovers. The stock market got affected (possibly due to confidence deficit), before the real economy.
- The external demand dependent nature of Bangladesh economy supports it potential areas of vulnerability
  - Revenue from merchandise exports
  - Remittances from services exports (from developed) countries
- Impact of two other areas remain more ambiguous
  - Flow of foreign aid
  - Net flow of FDI

IV. The Financial Meltdown: Implications for Bangladesh

- Due to lower global demand, prices of oil will decline. Food and other commodity prices remains stable. There may be a fall in inflation rate.
- Growth slowdown is yet to set in.

THERE IS A NEED TO SET UP A COMPETENT TASK FORCE TO ASSESS THE EFFECTS AND IMPACT TO DESIGN AN ADJUSTMENT PACKAGE WITH BOTH SHORT AND MEDIUM TERM POLICY AND INSTITUTIONAL MEASURES.

IV. The Financial Meltdown: Implications for Bangladesh

Second: How appropriate are the immediate steps taken by the Bangladesh Bank?

⇨ Bangladesh Bank has acted swiftly and in the right direction.

- Bangladesh Bank has moved 250 crore investment from different foreign banks.
- Bangladesh Bank has shifted its reserve from even least risky foreign banks
- Bangladesh Bank advised commercial banks to bring back their investments kept in nostro accounts.

⇨ BUT THERE ARE MORE TO BE DONE IMMEDIATELY

- Scrutinize the role of credit rating agencies. Have they solved information problems and increased transparency, or have they made the market more opaque?

IV. The Financial Meltdown: Implications for Bangladesh

- Review the sophisticated (and exotic) financial products, e.g. derivative instruments and interest swaps which are poorly understood by the market. The current regulatory stances create a bias against simpler financial instruments (i.e. cash instruments).
- Address maturity mismatches in non-banking financial institutions and limit involvement of banks with weakly regulated agencies.
- Focus on limiting credit deterioration linked to securitization. Keep some loans on the balance sheet.
- Improve transparency of corporate governance, operational modalities and product portfolio and fund movements of foreign banks. Brand names are no more guarantees!
- Remember ENRON bankruptcy due to off-balance sheet financing!

IV. The Financial Meltdown: Implications for Bangladesh

NEED FOR MACRO-ECONOMIC POLICY ADJUSTMENT

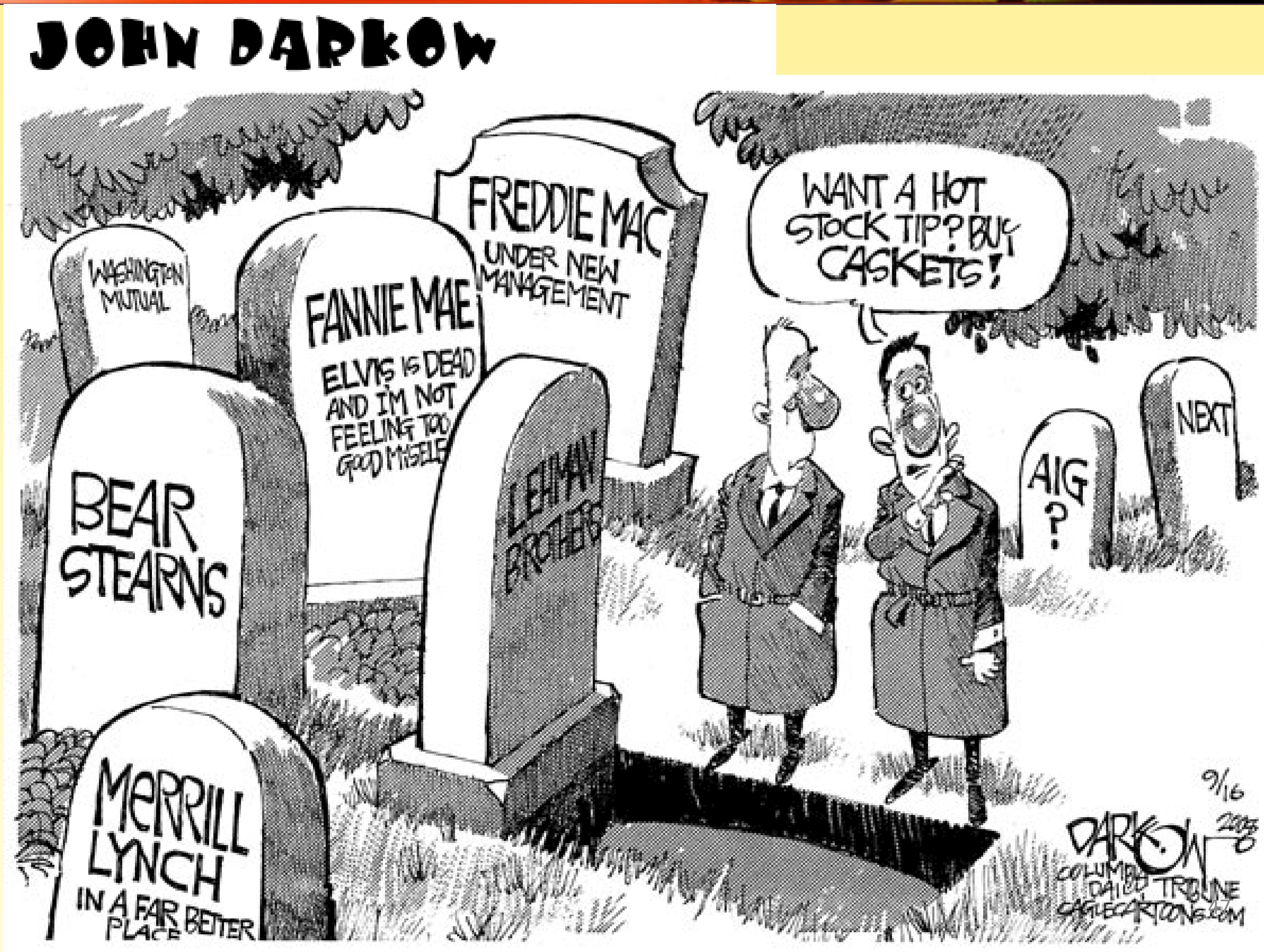
i. To compensate possible fall in external demand for Bangladesh's goods and services, measures needs to be taken to augment domestic demand.
   - by reviewing public expenditure portfolio to accelerate implementation of infrastructure projects.
   - by strengthening credit flow to build productive capacities, e.g. in agriculture, non-form activities, small and medium enterprises.

ii. Taking advantage of sobering trend in inflation, expansionary monetary policy may be pursued.

iii. Consider lowering interest rate in line with inflationary trend.

IV. The Financial Meltdown: Implications for Bangladesh

iii. Active management of exchange rate so that it does not fall victim of ensuing competitive devaluation.
iv. Intensification of export market exploration in emerging economies where economic slowdown will be less.
v. Consolidation of labour markets in the non-OECD countries, particularly in Middle East and South-East Asia.
vi. TO BUILD PUBLIC INSTITUTIONAL STRUCTURE TO SYSTEMATICALLY MONITOR GLOBAL TRENDS AND PROVIDE POLICY FEEDBACK.
vii. ENCOURAGE THE POLITICAL PARTIES TO TALK ABOUT THEIR POLICY PACKAGE TO DEAL WITH THE NATIONAL IMPLICATIONS OF GLOBAL CRISIS.


JOHN DARKOW
WASHINGTON MUTUAL
FANNIE MAE
ELVIS IS DEAD AND I'M NOT FEELING TOO GOOD MYSELF
FREDDIE MAC
UNDER NEW MANAGEMENT
WANT A HOT STOCK TIP? BUY CASKETS!
BEAR STEARNS
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Machiavellian dishonesty and greed have brought disaster.

Now, taxpayers must save Wall Street's sorry Fannie.

Washington completely failed to supervise the system.

Our financial capital is a citi in crisis.

Global finances are in a dangerous BEAR market.

Once seemingly reliable investments are now LEHMANs.

Retirees risk losing money in their old AIG.

In short, our economy Sachs.

We need strong, imb Indypendent overseers.

Folks, deregulation was nothing but a bunch of ...

Thank You
for
Your Attention