
Event Report

The Continuing Financial Crisis: Perspectives from the North and the South

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In March, Columbia University's Committee on Global Thoughts hosted Justin Yifu Lin as part of an afternoon series of lectures entitled "The Continuing Financial Crisis: Perspectives from the North and South." Mr. Lin's presentation focused on the fragile nature of the global recovery and the lessons and opportunities the economic calamity presents. Mr. Lin outlined three main points: the development of the economic recovery, ongoing government stimulus efforts and the need for global cooperation. In his introduction, Mr. Lin touched on each point, noting, "The recovery is quite fragile. We need to continue some type of government stimulus [and] look beyond the conventional wisdom of Keynesian stimulus. And, we need to establish global cooperation, which may turn the crisis into an opportunity for increased global coordination and a sustainable globalization."

Justin Yifu Lin is World Bank Chief Economist and Senior Vice President of Development Economics. He was previously Professor of Economics and Founding Director of the China Centre for Economic Research (CCER) at Peking University. Mr. Lin holds a PhD in economics from the University of Chicago and has authored numerous books and articles.

To highlight the fragility of the economic recovery, Mr. Lin noted that according to his forecasts, global GDP contracted 2.2 percent last year and will likely grow a paltry 2.7 percent this year, not nearly the "V-shaped" bounce many were hoping for in the developed world. Similarly, global trade flows fell roughly 14 percent in 2009, and Mr. Lin's forecasts call for only a 6 percent to 7 percent correction this year. Also of note, Mr. Lin stressed that much of the strength behind even these weak growth figures in 2010 is centered in developing economies, particularly in Asia.

Mr. Lin argued that the problem is excess capacity, which contributes to global unemployment. Interest rates remain very low through developed world monetary policy, yet this has not stimulated investment because capital, primarily provided in the Northern (developed) world, is having difficulty finding worthwhile investment opportunities in readily available Northern markets. Consequently, Mr. Lin stated, “We will see a very, very slow recovery.” The situation remains bleak in Northern countries such as the United States. Given that the FDIC reports that 702 banks are on its troubled watch list, Mr. Lin said, “a double dip is a real possibility.” (A double dip occurs when a post-recession economic recovery falters, and the world economy slips back into a recessionary environment.)

Leading into a discussion on government response, Mr. Lin then asked how governments can cope with such a bleak situation, because monetary policy, the typical Northern economic lever, may not work. The best central banks can do is to drive interest rates down to 0 percent, which is currently the case in the United States. But, if investment opportunities do not exist, nobody will invest. Furthermore, if there are no job opportunities, employment will not respond.

Mr. Lin suggested a better way might be to continue the fiscal stimulus programs many governments in both the North and South have implemented over the past two years. The prospect of additional government expenditure raises two issues in the minds of concerned parties in the developed world. First, there has been a sharp increase in public debt. Among high-income countries, Mr. Lin forecasts public debt will reach 120 percent of GDP by 2014, which raises a question of the sustainability of continued government borrowing. Second, Mr. Lin brought up the notion of Ricardian equivalence, in which people question the government’s ability to repay debt. As a result people increase savings, fearing higher taxes down the road as the government searches for revenue to service its obligations. Consequently, the issues of excess capacity will not be addressed.

The solution to these concerns, Mr. Lin claimed, was in the type of spending program the government implements. “We need to look beyond the conventional wisdom of Keynesian stimulus.” To highlight this distinction, Mr. Lin contrasted the experiences of Japan and China in using a government spending initiative to combat an economic downturn.

In the 1990s, Japan encountered similar situation to what the United States faces today. In response to poor economic performance, the Japanese government increased fiscal stimulus and government debt, consequently, exploded. The result was the Japanese “lost decade.” In the case of Japan, the Ricardian equivalence became a possibility because the government spending did

not invest in projects that increased the productivity of the economy. Thus, people feared the need to repay debt in future and increased savings. Mr. Lin completed his analysis of the Japanese stimulus program with a darkly humorous story relayed to him by a friend who lived in Japan in the 1990s. Mr. Lin’s friend lived in front of a road that was rebuilt six times in the four years that he lived there. This is exactly the type of nonproductive investment that governments should not pursue to stimulate their economies.

China, alternatively, used spending to invest in productive assets between 1991 and 2002, the same period as the Japanese “lost decade.” Mr. Lin noted that the number of miles in the Chinese highway system increased by a factor of five in the four years between 1998 and 2002. The Chinese average annual growth rate between the opening of its economy in 1979 and 2002 was 9.6 percent per year. Following the remarkable period of growth, many observers thought China would not be able to sustain such high rates of growth. However, between 2003 and 2008, the annual growth rate did not decline; rather, it increased to 10.8 percent, an increase of 1.2 percentage points. Mr. Lin noted, “A growth bottleneck was released by [productive] investment in early periods.”

However, as noted above, developed countries lack good opportunities for investment, even with interest rates near zero. Nevertheless, emerging market countries do have opportunities for investment that have potential for a high return. Mr. Lin feels the answer lies in a globally coordinated solution. North and South must come together to find a way to channel investment funds from high-income countries to developing nations. To do so, two issues must be addressed: coordination and implementation.

Coordination issues consist of setting up cross-border stimulus such that rich countries have an incentive to overcome free rider problems. This naturally requires global coordination, and Mr. Lin feels the solution lies within the G20, which can come up with a solution to this coordination problem with the right focus. Implementation issues consist of the necessary infrastructure, dispute resolution mechanism and framework to enable cross-border flows of investment funding. Mr. Lin points to the Bretton Woods system as an example of how to tackle these implantation problems. The Bretton Woods system was created to work through this type of issue, and Mr. Lin recommends a return to such an institution. Mr. Lin concluded by saying, “If we can work through these institutions, we can get out of global crisis.”

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