Critical thinking on effects of credit crunch ensuing recession on political econ...

Finance, Investment

Effects of credit crunch/ensuing recession on political economy decisions

The 2007-2010 economic crisis is perhaps the worst economic disaster to hit the globe since the Great Depression of the early 1930s. The crisis spread instantaneously across the globe triggering deep recessions in developed and developing economies (Hudson, and Maioli, 2010). Assets were devalued, financial markets became turbulent, unemployment levels rose, and access to credit became limited during the crisis. The onset of the financial crisis marked the end of the highest growth cycle experienced from 2003-mid-2008. The causes of the crisis can be attributed to surpluses in the current account of China and other oil-based economies, which provided the source of financing to the stock market and real-estate markets in America (Ocaya, 2012). The resultant effects led to low interest rates and lack of inflationary pressure in the American economy. This triggered increased debt levels among individuals and financial institutions in the United States thereby making the economy to outgrow its economic potential (Hudson, and Maioli, 2010). Eventually, the soaring debt levels and large account deficits destabilized the US economy. With the criticality of US economy to global financial system, the European economies and other emerging economies were soon to be affected.

Mexico in the Credit Crisis

Countries in Latin America felt the effects of the slowed down economic state. Mexico, an economy that shared close economic, political, and links with the United States, suffered a plunge in the volume of exports in addition to experiencing a contracted domestic economy. Largely, the Mexican economy relied on the US economy as the primary export market and the downturn of the US economy led to a decline in the Gross Domestic product (Sidaoui, Ramos-Francia, and Cuadra, 2009). The decline in the international energy prices decreased Mexico’s fiscal position due to declined oil revenues. Similarly, the Mexico’s sustained economic recovery depended on the recovery of the US economy. It is also important to note that remittance inflows from the United States accounts for the second-highest source of foreign currency after oil. Recessive labor market conditions in the US made it harder for immigrant workers to find and keep jobs, which presented a negative impact to the flow of remittances to Mexico. Access to international financial markets among Mexican firms was also constrained. Other than the excesses of the financial crisis, escalating violence led to the cracking down of organized crime and drug trafficking thereby affecting investor uncertainty. As a result, foreign direct investment experienced a sharp decline and subsequently leading to adverse effects on the manufacturing industry. This translated to significant job losses and increased unemployment levels.

These effects presented the Mexican government with long-term policy implications for increasing prospects of economic growth. Increasing productivity, lowering the rate of poverty, and promoting sustained growth in Mexico called for the implementation of sustained structural reforms (Sidaoui, Ramos-Francia, and Cuadra, 2009). These reforms included the implementation of measures to eliminate extreme poverty levels, privatize the oil sector, overhauling public finances, and adopting labor reforms. Prior to the financial crisis, Mexico had managed to reform its macroeconomic policy frameworks leading to strengthened economic fundamentals. Elimination of large and persistent budget deficits became possible through the implementation of the prudent fiscal policy management framework. A stable macroeconomic environment led to the development of financial markets that availed financial resources to the economy (Sidaoui, Ramos-Francia, and Cuadra, 2009). Another major improvement was evidenced in the solid position of domestic financial markets coupled with the existence of rigorous legislations implemented to set credit limits to related parties and parent banks.

China in the Credit Crisis

The surplus savings in China contributed to the financial turmoil that affected the US subprime mortgage sector that eventually led to the escalation of the financial crisis. China's high saving rates played a part in increasing the surplus in its current account. These surpluses were loaned to the United States to strengthen its position to purchase imports. With the growing power and global presence of China in the world economy, there is no doubt that it is gaining foothold as the world's strongest economy. Critics argue that the economic superpower of China can be attributed to its ability to embrace the market economy using utterly brutal means. Capitalism and one-party communism are some of the factors that enabled the Chinese economy to address effects of the financial crisis. There is no wonder that the Chinese suffered from the effects of economic ideologies put forward by

Friedrich Hayek given the levels of ease in accessing Chinese credits and embarking on overambitious projects. According to Hayek, bad investments lead to hard economic recoveries and this explains the woes that are currently being experienced in China.

China’s involvement in the global economy subjected it to the effects of the economic downturn. The rate of economic rate declined steadily from 14%, 9%, and 6. 1% in 2007, 2009, and at the first quarter of 2009 respectively (Chow, 2010). The Chinese economy suffered external shocks from the free fall in international demand and the collapse of commodity markets. For the past two decades, foreign direct investment and international trade accounted for US870 billion and US$2. 56 trillion respectively (Chow, 2010). Equally, $1. 95 trillion of Chinese foreign reserves is invested in foreign agency and government bonds. An estimated 25 million Chinese employee’s work for foreign companies with operations in China. With all these factors, there is no doubt that the Chinese political and economic health is reliant to the global economic markets. These interconnections means that any undesirable developments in global markets presents undesirable effects to the Chinese economy.

China suffered the pains of the credit crunch in other ways. The shrinking international trade resulted to a reduction in China’s involvement in international trade. Small-and mid-sized manufacturing and trading companies collapsed leading to job losses for over 20 million migrant Chinese workers. Chinese trade relations with the European Union and the US were impacted significantly (Chow, 2010). Majority of these markets formed the largest consumers of Chinese exports, and the effects of the credit crisis led to slowed purchases of Chinese goods.

Policy Responses to the Credit Crunch

China

Political responses in response to the effects of the credit crisis included a call for rejecting economic reforms in favor of the centrally-controlled economy implemented by Mao. Another possible political response included the adoption of a protectionist/nationalist approach to Chinese growth investments. Hardening attitudes concerning politics and trade with partners such as the US to prevent such trade partners from frustrating its growth efforts. In efforts aimed at addressing the external shocks associated with the credit effects of the credit crisis, the Chinese government announced a number of macroeconomic policies. Among these policy response was the 4 trillion Yuan (US$586 billion) stimulus package to be implemented for the duration 2008-2010. This stimulus package was aimed at stimulating domestic demand (Chow, 2010). This translated to the inflation of China’s fiscal deficit from 0. 1% in GDP to 2. 9% of GDP in 2010. While this stimulus package targeted three economic pillars (funding mechanism, industrial policy, and investment plan), the stimulus package was criticized for relying heavily on physical infrastructure. Also included in the stimulus package plan was the innovation and competitiveness plan that targeted 10 additional factors. Contrary to their believe of the Keynesian economy as a general theory aimed at defending capitalism, the Chinese government headed by Wen Jiabao and Hu Jintao embraced Keynesian prescriptions. The leadership regimes of Li Keqiang and Xi Jinping are expected to suffer the investment effects described by Friedrich Hayek (The Economist, 2011).

Another policy response was the implementation of the expansionary fiscal policy by exiting from its tight monetary policy. The new expansionary monetary policy enabled the government to cut interest rates and minimize bank reserve requirement ratio to improve the liquidity volumes on the banking system. The effectiveness of several industrial policies implemented to promote the growth and recovery of particular sectors in the economy is yet to be evaluated. The stimulus package is likely to increase China's reliance on investments that depend on the growth model because inappropriate use of money on key sectors. The Chinese stimulus program is criticized for relying heavily on imbalanced and unusual investment burst through bank lending, enhancing the role of the state at the expense of the private sector, and exacerbating china's dependence on exports. The stimulus package is also criticized for neglecting consumption because the package was aimed at expanding investment demand.

Maintaining a stable exchange rate is also another measure that is certain to improve the effectiveness of the fiscal expansionary policy. This is possible with the implementation of the Renminbi exchange rate controlled to be bring the desired effects.

Mexico

Unlike China, Mexico's government openly implemented the reforms presented by Keynesian economists. Past responses to macroeconomic issues included the implementation of measures aimed at reducing public debt, adoption of inflation targeting framework, a floating exchange rate policy, and introduction of a balanced budget rule. Responses to the effects of the 2007-2010 financial crisis included targeted assistance to financial institutions, macroeconomic policies, and actions aimed at improving the investor confidence. The Mexican government implemented tightened monetary policy, unlike China, in order to widen differentials in interest rates among developed economies and Mexico. The fiscal entailed the implementation of a balanced budget rule in accordance with the Federal Budget and Fiscal Responsibility Law (Villarreal, 2010).

Substantive tax reforms were also adopted to offset revenue losses suffered as a result of low oil revenues. Reforms presented by President Felipe Calderon were viewed as being highly controversial with deep-seated political implications. The fight against escalating violence, drug trafficking, and organized crime has contributed to increased risk aversion that have direct effects on foreign investment flows. Relationships between Mexico and the United States is key in the development of bilateral trade between the two countries.

Final Remarks

The worsening effects of the credit crisis had significant pressures on emerging economies such as Mexico and China. Both countries succumbed to adverse shock in form of collapsed export demands for Mexico and China, and limited access to external financing for Mexico. Domestic financial markets deteriorated and domestic growth plunged. Mexico and China responded in varying ways to the global recession. Political and economic decisions adopted in response to the effects of the economic crisis included introduction of a fiscal stimulus package, encouraging domestic investment and foreign direct investment, and income distribution are among the areas where there was a great sense of similarities in decision making. On the extreme, the Chinese government implemented mixed political responses but some of these policies are yet to be implemented. While China thought of implementing tough policy measures to countries such as the US and EU (Chow, 2010), Mexico, on the other hand, believed in strengthening relationships with the US because its economic recovery heavily relies on the growth of the US economy.

References

Chow, D. (2010). China’s response to the global financial crisis: Implications for US-
China Economic relations. Global Business Law Review, 47-81

Hudson, R. and Maioli, S. (2010). A response to " Reflections on a global financial
crisis. Critical perspectives on international business, 6(1), 53 - 71

Ocaya, B. (2012). The current global credit crunch; a review of its causes, effects,
and responses. Online Journal of social sciences research 1(6), 166-177

Sidaoui, J., Ramos-Francia, M. and Cuadra, G. (2009). The Global financial crisis
and policy response in Mexico. BIS Papers No. 54, 279-297

The Economist (November 17th, 2011). Keys v Hayek in China. Retrieved from
http://www. economist. com/node/21537010

Villarreal, M. A. (2010). The Mexican Economy after the global financial Crisis.
Congressional research service. 1-21