Global Financial Crisis and Recession
Experiences from the past and lessons for Bangladesh

Ahmed Taneem Muzaffar*
Assistant Professor
Department of Economics
East West University Bangladesh
43, Mohakhali Commercial Area, Dhaka 1212.
Telephone: 880 2 9882308 x 126
Email: taneemm@yahoo.com

Parvez Karim Abbasi
Lecturer
Department of Economics
East West University Bangladesh
43, Mohakhali Commercial Area, Dhaka 1212.
Telephone: 880 2 9882308
Email: parvez_abbasi@yahoo.com

Md. Abid Hossain Khan, ACA
Manager
Taxation and Fiscal Compliance
Finance Division
Grameenphone Limited
Telephone: 88 0 1711080866
Email: abid9khan@yahoo.com

* Corresponding Author
Submitted to The GBMF 2009 Conference
December 2009, University of Dhaka, Bangladesh.

Global Financial Crisis and Recession
Experiences from the past and lessons for Bangladesh

Abstract

The recent financial crisis happened globally led to one of the most severe recessions in several decades. Due to its greater degree of openness Bangladesh economy was not out of the adverse impact caused by this crisis. This paper primarily investigates the issues responsible for setting off the crisis, the ways in which it might impact the Bangladesh economy, and the initiatives the government takes to buffer against the worst effects of this global event.

Introduction

The recent financial crisis and recession grappling the world economy are expected to have a considerable impact on the economy of Bangladesh. There is a debate over the severity of the consequence but it would surely impede the country's progress and aim of achieving the objectives set by the Millennium Development Goals (MDGs). This paper makes an attempt to review the key issues responsible for triggering the global financial crisis that led to supposedly one of the worst recessions since the Great Depression of the 1930s, how it might affect the Bangladesh economy, and the level of policy preparedness by the government to create a cushion against the adverse effect of such event.

Methodology

The discussion and findings presented in the paper are mainly done after reviewing secondary literature and summarizing the issues that came out from several key informants' interviews (KII) during the months of April and May 2009. The secondary sources of information include materials from published journal articles, various written works published in reputed newspapers, magazines, and web pages. The KII was performed in a structured format on a number of participants including economists, bankers, stockbrokers, and other persons relevant to financial institutions. In line with the objectives of the study, an attitudinal survey was carried out in June and July 2009 using a purposive sampling technique in selecting sample respondents. The respondents who were interviewed using a questionnaire were of six groups from Dhaka and Chittagong, Bangladesh.

Table 1: Sample respondents for attitudinal survey

Type of person interviewed	Frequency	Percentage
Economist by profession	6	6%
Bankers	20	23%
Stockbrokers	15	17%
Entrepreneurs	25	28%
Academicians	10	11%
Others	14	15%
Total	90	100%

Source: Questionnaire Survey June and July 2009.

Table 1 summarizes the respondents in different groups. A total of 90 persons in the two cities responded to the questionnaire, entrepreneurs and bankers being highest amongst them. Opinions expressed by the respondents in respect of financial crisis and recession were analyzed through 5 point bi-polar scale system using spreadsheet. In this scale 5 indicates full agreement, 4 medium agreement, 3 no comment and on the contrary 2 indicates medium disagreement, while 1 represents strong disagreement.

A Review of Related Literature

A large number of published papers exist in the literature, ranging from orthodox viewpoint to the middle ground theories, to explain the financial crises.

Chart 1: A Chronology of Financial Crisis in Recent Decades

Yong (1999) agrees to the standard or widely accepted viewpoint that crony capitalism, lack of proper regulation and monitoring and nepotism were the root causes of the Asian Financial crisis in general. He endorses Paul Krugman's influential "Third Generation Model" by identifying that crooked banking practices and rampant corruption and nepotism by the government helped sow the seeds of financial crises in the East Asian economies in the 1990s. Yong points out that unabated crony capitalism eroded fundamentals of these economies and make them more vulnerable to financial speculative attacks. He rules out the possibility of contagion and irrational "herd-like" investment by the foreign investors. Deploring the *cozy* relationship between the Governments and the major business conglomerates, the author advocates restructuring of the banks and strengthening of the fundamentals of the regional economies.

Strange (1989) argues against deregulation of the International Financial markets because of its inherent volatility and instability. The author identifies the present system to be potentially instable as well as uncontrolled. According to the author speculative activity in the financial markets is often undertaken without prior information or understanding and is almost akin to betting in the dark. However, the disastrous consequences that often stem from these ill-informed and ill-judged actions adversely affect the livelihood of millions of people around the world. She states that International organizations are powerless to control or even monitor the financial markets and suggests that the

American authorities should intervene in the market by taking control of the major institutions dealing in dollars thereby avoiding the adversities of casino capitalism.

Strange (1998) further analyzes the nature of change and innovation in financial businesses and discusses the weak points, political as well as economic and technical, of a system driven more by volatile markets than governments. The analysis includes the causes of the crisis in developing countries such as Mexico and East Asian nations in recent decades.

Woodward (2001) raises questions about enthusiasm over attracting Foreign Direct Investment and Portfolio Equity Investment to the developing countries and points towards a possible peril that it poses. He draws attention to the risk of substantial outflows of resources and the massive shift towards foreign ownership. His work shows how FDI may have actually contributed to the Asian Financial crises and could in the future lead to a new wave of similar financial crises in the developing world.

Ross (1994) in his work presents a broad, sweeping overview of economic and political developments and the state of the financial sector in Indonesia until 1994. The work compiles the different viewpoints of academics and policymakers on the range of financial reforms that were being undertaken in the country and the impact of greater capital inflows on the Indonesian economy. It specially focuses on the reform process that was initiated in the late 1980s and early 1990s and deals with the sequencing of economic deregulation in Indonesia, the banking sector reforms of 1993-94, the development of the Indonesian capital market and privatization and the issue of debt-financing by the government. The book provides a clear picture of Indonesia's financial sector prior to the crises.

Zarsky (2005) holds a detailed and thorough examination of the relationship between sustainability, development and governance of international investment. Similar to the work by Woodward (2001), it argues that foreign direct Investment and portfolio investment are not the magical elixir for developing countries and exposes flaws in the international investment regime. The author then goes on to suggest new ways for creation and implementation of international investment rules that will promote global sustainability and equity.

Radlett and Sachs (1998) argue that a molehill - problems in Thailand - was turned into a mountain - a regional financial crisis - because of international investors' irrational behavior and the overly harsh fiscal and monetary medicine prescribed by the IMF as the crisis broke. They point to several factors that support the premise that the crisis was panic induced. First the crisis was largely unanticipated. There were no warning signals, such as an increase in interest rates on the region's debt or downgrading by debt rating agencies. This as the authors suggest is particularly true in the case of Indonesia as it had obtained a positive review from IMF and had healthy credit ratings prior to the crisis. Second, prior to the crisis, there was substantial lending to private firms and banks that did not have any sort of government guarantee or insurance.

The Origin of the Current Crisis

The global financial crisis that started in the year 2007 and leading to economic downturn is deemed to be one of the worst of its kind. It originated due to collapses of big financial institutions in the United States and quickly turned into a global crisis causing a number of European bank failures and declines in major stock indexes thus resulting in large reductions in the market value of equities and commodities worldwide. A consequence of the crisis is liquidity problem and de-leveraging of financial institutions in the United States and Europe that in turn speeded up the liquidity crisis.

One of the main reasons of the crisis is rooted in the US mortgage market particularly in the *sub-prime*[1] loan market evolving since the mid 1990s and focusing on households with weak credit worthiness. As part of a political ploy, the US government initially wanted the low-income households to become homeowners in an easy way. The task to implement this goal was given to the public institutions, The Federal National Mortgage Association (Fannie Mae) and The Federal Home Loan Mortgage Corporation (Freddie Mac). The US Federal Government created the Fannie Mae after the Great Depression and in due course of time it turned into a private credit institution simultaneously having the status of a government entity. The function of Fannie Mae largely comprised of underwriting loans sanctioned by other credit agencies. On the other hand Freddie Mac was founded in 1970 having the same fundamental structure and purpose as Fannie Mae. On September 7, 2008, the federal authorities took over the two institutions since both of them were under severe condition due to the crisis to which they themselves were largely responsible for (Ahmad, 2009). The reason is that the institutions in the prior months were in charge of 70 percent of the mortgages in the United States providing a signal of their decisive role in the market where the crisis first occurred (Ahmad, 2009). The peculiarity in the design of the institutions before the take over by the federal government was also a cause of the problem. As mentioned earlier, on one hand Fannie Mae and Freddie Mac were government entities aiming at fulfilling political goals for which they received considerable amount of subsidies; on the other hand, they were private businesses objectives of which were to maximize value of the shareholder. Using the public subsidies - the former - the political intention was to bring down the cost of sub-prime mortgages while the latter disabled market risk analysis by falsely deflating the mortgage costs. They focused on increasing the sub-prime mortgages whose beneficiaries prompted the crisis by defaulting on their payments. In short, drawing on large subsidies, Fannie Mae and Freddie Mac guaranteed mortgages granted to individuals who did not qualify for ordinary loans. At the same time, regulations were introduced persuading banks, in certain cases, to extend credit to borrowers with insecure assets.

Monetary policy is also an underlying cause of the current financial crisis. In order to alleviate the economic downturn, the US Federal Reserve slashed the federal funds rate to very low levels after 2001 thus creating a mortgage bubble (Andrews, 2008). For instance, in 2003, the interest rate for 3-month treasury bills was as low as one percent.

[1] Sub-prime mortgage: A loan or mortgage given to a person or an institution is sub-prime when the recipient's credit rating is poor or collateral base is inadequate. The rate of interest charged in this case is usually higher than normal and the risk associated with recovery is high.

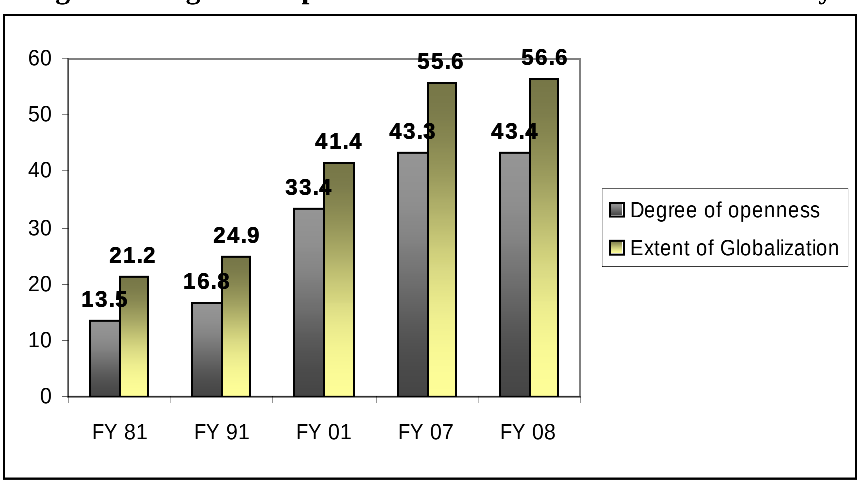
During the period of 2003 to 2005 the Fed kept the interest rates below the expected inflation rate, maintaining a negative expected real cost of borrowing, and heavily subsidizing loaning. This helped create a housing bubble. In addition, the banks were convinced of a possible bail out by the government in case of a dire financial strait. There were warnings from numerous experts and commentators whistle blowing about the current crisis. However it was not effective and there was no urgency to take precautionary measures during a period of healthy economic growth. Consequently, the global recession followed.

International Monetary Fund, in April 2009, said that the global economy is likely to shrink by 1.3 percent this year the first such decline in six decades. The group of seven major economies (G7) namely USA, UK, Canada, France, Germany, Italy, and Japan, said that the worst global slump since the 1930s Great Depression appeared to be approaching a bottom but also warned the outlook remained highly uncertain.

The Recent Economic Trend

The global economic crisis surfaced at a time when Bangladesh economy was experiencing a decent average growth rate of 6 percent over the last six years contributed mainly by industrial and services sectors (Figure 2). In recent years, the economy has integrated with the rest of the world quite rapidly. The exports constitute 17.8 percent of GDP while export of goods and remittance together constitute 25.8 percent of Gross National Income. The degree of openness (export and import as a percentage of GDP) of Bangladesh stands at about 43.4 percent (Figure 1). About 85 percent of Bangladesh's exports go to developed countries and on the other hand these account for around 33 percent of Bangladesh's imports. Because the country is intertwined quite closely with the rest of the world the impact of global recession is likely to have important implications for Bangladesh.

Figure 1: Degree of Openness and Globalization of the Economy

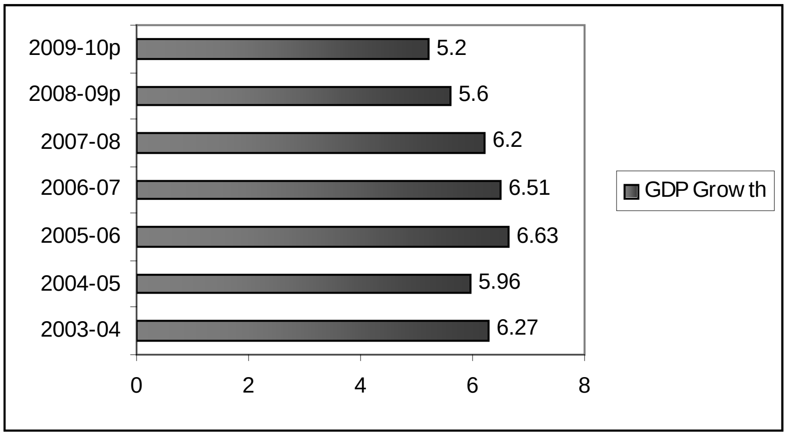


Source: Adapted from Center for Policy Dialogue (2009a).

The Asian Development Bank (ADB) projected the lowest GDP growth for Bangladesh in five years for the current fiscal year as a result of global recession (Figure 2). ADB forecasts this year's growth at 5.6 percent down by 0.6 percent points of the previous year's achievement and around 1 percent point lower than central bank's projections of

6.5 percent for the current fiscal year. The country could achieve over 6 percent growth since 2003-04 with the exception of 5.96 percent growth in 2004-05 due to flooding resulting in lower agricultural production.

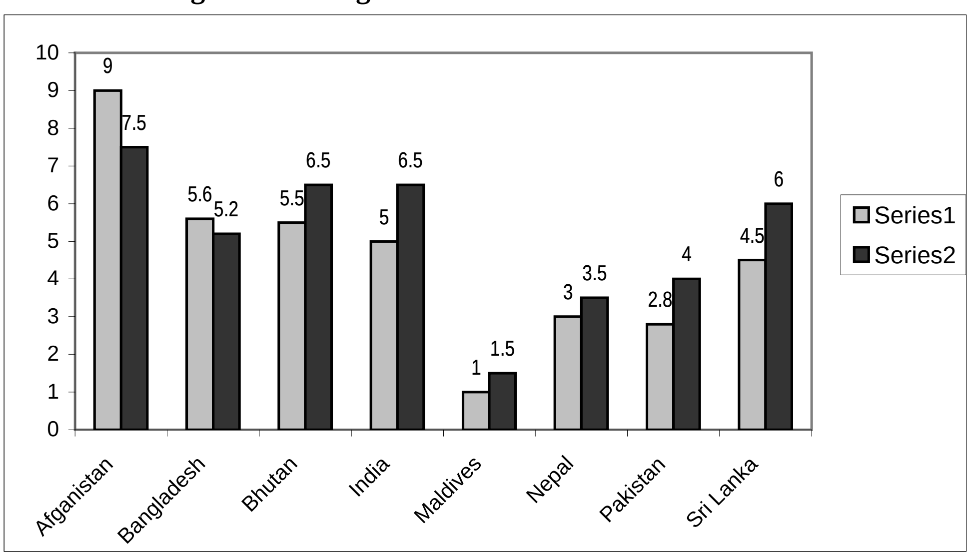
Figure 2: GDP Growth Rate of Bangladesh Economy



Source: Asian Development Bank website. NB: Projected figures are reported for 2008-09 and 2009-10.

Compared to its neighboring countries, Bangladesh's growth shows a declining trend as well (Figure 3). Based on semi-annual economic review of the economy, the World Bank warns of a danger that the domestic economy could descend into a downward spiral of reduced export and remittance growth, leading to lower GDP growth and higher unemployment.

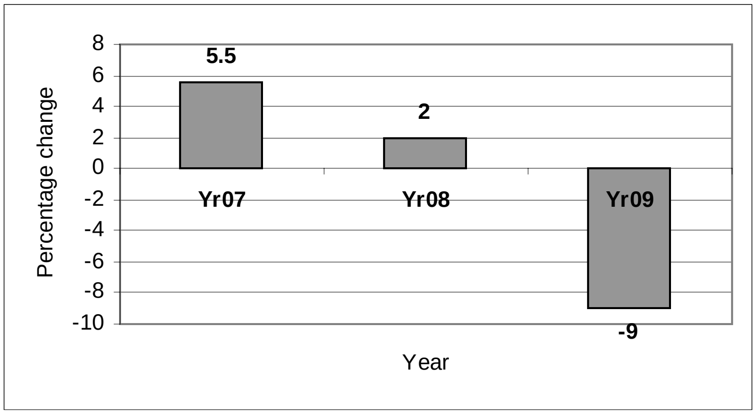
Figure 3: GDP growth in the South Asian countries



Source: Asian Development Bank forecast on the growth of GDP of South Asian countries from web site. NB: Series 1 and series 2 refer to year 2009 and 2010 respectively.

Overall export growth is seen by the World Bank as volatile, falling considerably to a monthly decline of 3.0 per cent by February 2009. One of the reasons is shrinking percentage of world trade due to the recession (Figure 4). The World Bank reports that sapping consumer spending in developed economies and the collapse in global trade would have an increasingly adverse impact on Bangladesh. The highest export earning source apparel exports have fallen significantly from 59 per cent at the beginning of the year to 19 per cent in February 2009.

Figure 4: Percentage Change in World Trade



Source: Adapted from websites of World Trade Organization and AFP.

On the remittance side, the monthly growth rate slowed from 44.7 per cent in July 2008 to 9.0 per cent in March 2009, the lowest in this fiscal year so far. A major share of Bangladesh's remittances, about 63 percent, comes from the Middle East, which employs over 3.6 million Bangladeshi workers. The dreary performance of many Gulf Cooperation Council (GCC) countries is negatively affecting work opportunities for migrants from Bangladesh and therefore, future remittances as viewed by the World Bank.

The global meltdown is also exerting a considerable downward pressure on both demand and price of a number of Bangladesh's non-RMG exports. For instance, frozen shrimp, a major export item, has witnessed a steep decline in price from US$5.0 per kg to US$3.7 per kg. The depreciation of UK pound sterling with respect to US dollar has caused profit margins for vegetable exporters to shrink. Jute millers and spinners of the country have reduced their production by 25-30 per cent due to the decline in demand for raw jute and jute goods from rest of the world.

According to Asian Development Bank’s *Asian Development Outlook 2009* report, industrial growth will slow to 6.6 percent this fiscal year from 7.6 percent last year primarily due to the falling export demand. The service sector growth as the report suggests will drop to 6 percent from 6.7 percent in 2007-08 as a consequence of sliding consumer spending. The report expects inflation to be at an average of 7 percent this fiscal year a significant decline from 9 percent projected earlier as a result of falling global commodity and fuel prices. Inflation is predicted to remain at about 6.5 percent in FY 2009-10.

Policy Initiatives for Remedies

To tackle the imminent impact of the global crisis, policy preparedness and timely action are required as suggested by the experts. The Government of Bangladesh announced on April 19, 2009 an interim package of fiscal and policy supports for the country’s agriculture, power and export sectors to help combat the immediate effects of the ongoing global recession (Table 2). To finance the package an additional allocation of Tk 34.24 billion will be needed in the revised budget for the current fiscal year. Under the fiscal support part of the package for the April-June period of the FY 2008-09, the rates of export subsidy have been increased for three sectors which are jute, leather, and frozen food. With the raise, the rate of cash subsidy on jute and jute goods has gone up to 10 per cent from the existing 7.5 per cent while the same has increased to 17.5 per cent from 15 percent for leather and leather goods and 12.5 per cent from 10 percent for frozen foods (Figure 6). Cash support rates for other export items remain unchanged. Because of the increase in export subsidy to three sectors the government would require to allocate an additional amount of Tk 4.50 billion. Consequently, the total amount of export subsidy would rise to Tk 15 billion in the revised budget for the FY 2008-09 as opposed to the existing allocation of Tk 10.50 billion.

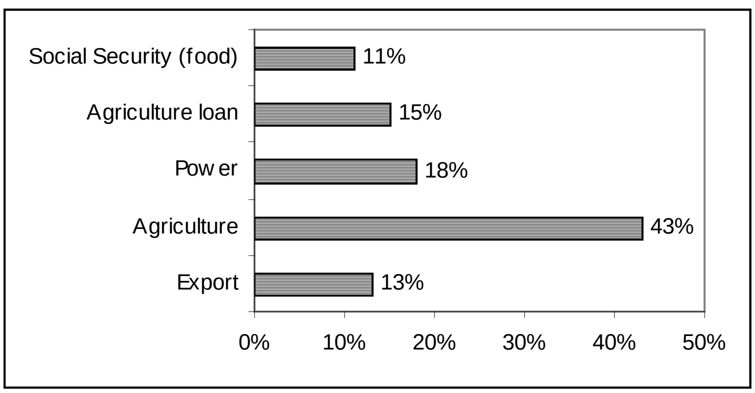
Table 2: Fiscal and Policy Support for FY 2008-09

(Figures in crores of Taka)

Areas	Existing	Additional amount	Total
Exports	1050	450	1500
Agriculture	4285	1500	5785
Power	600	600	1200
Agriculture loan (re-capitalization)	1000	500	1500
Social security (food)	4195	374	4569
Total	11130	3424	14554

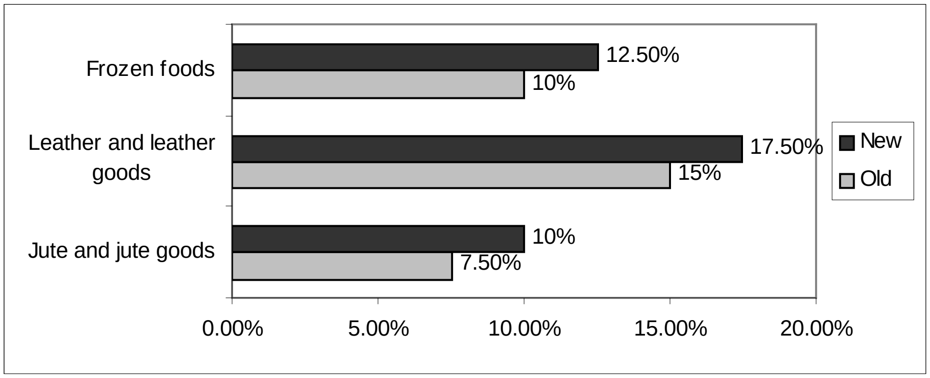
Source: Ministry of Finance, Government Republic of Bangladesh

Figure 5: Percentage Share of the Support



Source: MOF, GOB.

Figure 6: Percentage Increase in Cash Incentives



Source: MOF, GOB.

The government has also made an attempt to help the local shrimp operators boost their productivity by achieving quality standard set by the European Union. Attempts will be taken by the government to identify the causes behind the failure of the local pharmaceutical and ceramic industries for not being able to achieve their respective export targets.

On the remittance front, the government plans to strengthen its diplomatic efforts in the countries, especially where large numbers of Bangladeshi people are employed, to help protect their jobs and also explore new markets for employment.

The Tk 34.24 billion stimulus package, which has focuses on domestic fronts by prioritizing power and agriculture sector, is expected to bring positive result in the long run. There are signs that the government is trying to ward off the negative impact of the global recession on the export sector by paying attention to issues such as increasing competitiveness and reducing cost of production. For instance the cost of production will go down allowing export sector to increase its competitiveness eventually, if power production goes up.

The initiatives taken by the government also suggests that to weaken the effects of global recession, the government is reviewing public spending and strengthening social safety nets to help come through the storm of the global crisis. In a continued effort, the government is likely to set forth a big budget of Tk. 113000 crore for the next fiscal year to allocate more money for social safety nets, subsidies, development programmes, and additional salaries for government staff. It would possibly be 13 percent bigger than the current fiscal year's original budget of Tk. 99,962 crore, and about 18 percent larger than the probable revised budget. Economists, however have enough doubts about how much implemental the new budget will be, considering the implementation efficiency and quality.

Results from the Attitudinal Survey

Table 3 below summarizes the results from the attitudinal survey.

Table 3: The t-Test Results

Statements Tested	Scores	Remarks (t-Test Result)
Greater degree of openness does not lead to crisis and economic downturn in Bangladesh.	1.58	Insignificant
Growth target for next fiscal year will not be a challenging task due to deepening global economic crisis	1.52	Insignificant
Credit to SMEs does not need to be increased	1.78	Insignificant
Remittance does not affect national savings	1.82	Insignificant
Low implementation of ADP is not a problematic characteristic of public expenditure	1.73	Insignificant
Industrial development will not be adversely affected by the fall of credit disbursement	1.79	Insignificant
Rural inflation rates do not tend to be higher than urban inflation rate	1.84	Insignificant
Appreciation of domestic currency will not make domestic product's price less competitive	1.61	Insignificant
Food security issue should not receive foremost priority	1.76	Insignificant
Share price fall in the country is not due to global crisis	1.87	Insignificant
A greater initiative should not be taken to increase export earnings and remittance flow.	1.89	Insignificant

Source: Questionnaire survey, June and July 2009.

Opinions expressed from the respondents cover a range of issues pertinent to current economic circumstances of the economy. One of the causes of economic downturn in Bangladesh is perceived to be its greater interaction with the rest of the world and it would be difficult for Bangladesh to meet the growth targets in the near future. Opinions suggest that careful attention should be paid to boost industrial growth, particularly SMEs by providing credit, and to ensure a steady flow of export earnings and remittance to steer the economy out of this turbulent period. One concern in the external sector is domestic currency becoming stronger against foreign currency making Bangladeshi products more expensive to the foreigners thereby having an adverse effect on export. Internally, proper execution of ADP is a major concern. Government should also gear up programs addressed to food security of the country with specific attempts to curb rural inflation.

Conclusion

Since the early 1990s the policies of successive governments of Bangladesh, in general, aimed at trade liberalization thereby opening up the economy. Thus the economy of Bangladesh started to become closely connected with the global economy, utilizing the benefits of it and exposing itself to external shocks at the same time. On the positive side, the country could achieve a significant level of export growth adding a momentum to the development initiatives. The adverse effects, on the other hand, account for inflationary pressure due to rising oil price and commodity prices in the international market and the recent global recession. The successive governments of Bangladesh showed their awareness to identify these key challenges arising from global developments and trying to come up with devices to counteract the adverse effects. What Bangladesh could do is to explore the opportunities to expand its exports, investments, and growth through better connectivity and trade with regional countries. In addition the transaction costs of remittances and investments by expatriates could be reduced in an attempt to attract more money from the migrants and injecting it in the development process.

References

Ahmad, Q. K., (2009), "Global Financial Meltdown and State Responses" *Business Report*, A finance and business fortnightly, February 10-25, 2009, website: www.businessreport-bd.com

Alan, F., and Gale, D., (2007), *Understanding Financial Crisis*, Oxford University Press.

Andrews, E. L., ((2008), "Greenspan concedes error on deregulation", *The New York Times*, published on October 23, 2008, website: http://www.nytimes.com/2008/10/24/business/economy/08econ.html

Center for Policy Dialogue, (2009a), *Development of Bangladesh with Equity and Justice: Immediate tasks for the new government*, Independent Review of Bangladesh's Development 2008-09, Center for Policy Dialogue, Dhaka, Bangladesh, website: www.cpd-bangladesh.org

Center for Policy Dialogue, (2009b), *Bangladesh Economy in FY 2008-09: An interim review of macroeconomic performance*, A report prepared by the CPD under the programme Independent Review of Bangladesh's Development (IRBD), Center for Policy Dialogue, Dhaka, Bangladesh, website: www.cpd-bangladesh.org

Prothom Alo, various issues from the Internet, website: www.prothom-alo.com

Radlett, S. and Sachs J., (1998), *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, Harvard Institute for International Development, United States.

Ross, McLeod H., (1994), "Indonesia Assessment 1994 - Finance as a Key Sector in Indonesia's Development." *Research School of Pacific and Asian Studies*, Australian National University, Canberra, Australia.

Strange, Susan, (1998), *Mad Money - When Markets Outgrow Governments*, University of Michigan Press, Ann Arbor.

Strange, Susan, (1989), *Casino Capitalism*, Basil Blackwell Ltd, UK.

The Asian Development Bank, website: www.adb.org

The Daily Star, various issues from the Internet, website: www.thedailystar.net

The Financial Express, various issues from the Internet, website: www.the**financialexpress**-bd.com

The International Monetary Fund, website: www.imf.org

The World Bank, website: www.worldbank.org

The World Trade Organization, website: www.wto.org

Tirole, J., (2002), *Financial Crisis, Liquidity, and the International Monetary System*, Princeton University Press.

Woodward, David, (2001), *The Next Crises? Direct and Equity Investment in Developing Countries*, Zed Books Limited, London, United Kingdom.

Yong, Richard Y.C., (1999), "Lessons from the Asian Financial Crisis", *Cato Journal*, Vol. 18, No. 3, Cato Institute.

Zarsky, Lyuba, (2005), *International Investment for Sustainable Development*, Earthscan, United Kingdom.