

# **The Global Economic Crisis: Challenges and opportunities for public administration<sup>1</sup>**

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## **I Introduction**

The recent global economic crisis has brought fresh attention to the issue of the role of governments and public administration in preventing such crises, and in managing them when they occur.

Since about the mid-1980s, the mainstream thinking on growth and development has veered towards de-emphasizing the role of governments and the public sector in undertaking direct economic activity, providing greater space for markets. Smaller government, deregulation and pursuit of profit became the tenets of the new ideology that guided public policy. In this new paradigm, faith is placed in the efficiency of markets to self-adjust themselves to economic events, and produce outcomes that are efficacious for the citizen. The growth of such market fundamentalism led to an unquestioned acceptance of the benefits of general and limitless financial liberalization and financial intensity in the growth of market economies.<sup>2</sup>

Following this philosophy, many governments embraced privatization of public sector functions or enterprises. Foreign trade was liberalized and restrictions on financial flows across borders were removed. Trade and capital flows were liberalized to a point where a large chunk of the global economy now functions as a unified economy, with the space for national economic decision-making diminished.

The onset of the global recession from 2007 onwards, however, has exposed the inability of governments to contain and manage the crisis – with economic growth in large parts of the world turning negative, millions of workers losing jobs (e.g. one million in South Africa in 2009), and households losing their precious savings and dispossessed of their houses (e.g. the U.S.).

Industry and governments were caught off guard by the magnitude of the crisis and its speed when it erupted in 2008. While rescue efforts were put in place in the US and elsewhere with some speed, it remains a major challenge.

## **II The challenges posed by the global economic crisis**

The question, then, is: was this inevitable? Was it an inevitable part of the market-led economic growth processes? Or, can growth processes be managed better, with a better defined role for – and better positioned – public sector?

It is clear that much of the turmoil in the global economy and the deleterious developments in it could be traced to certain weaknesses in the economic and political management at the national and global levels.<sup>3</sup>

- *Globalisation of the world economy*: while the opening up of borders to trade, capital flows and financial services across the world has spurred specialization and productivity gains, and contributed to growth in the industrial and other selected parts of the world, it had, at the same time, exposed many countries to greater vulnerability to global developments. For example, the build-up of large export surpluses by some countries, such as the Peoples Republic of China, found expression in a sharp increase in short-term flows of capital across countries, exposing the international economy to greater vulnerability.
- Driven by electronic technology, the greater role of markets and the magnitude of financial flows, *a crisis now spreads more rapidly* from one country to another, magnifying it in the process.
- The *abolition of the Glass-Steagall Act by the US* in 1999, originally enacted in the final years of the Great Depression of the 1930s and which prohibited commercial banks from acting as investment banks or owning a firm dealing in securities, had the effect of inducing the banks to ‘play’ the markets for quick profit.
- A growth of ‘*short-termism*’ in decision-making by banks and other market players induced by a ‘bonus-earning’ culture of decision-making. Bankers being tempted into speculation and away from ‘real’ banking.
- A *change in the accounting practices of banking institutions* from valuing assets at prices at the time of acquisition, to current market values (mark to market) – a task that was complicated and open to fluctuation. The vulnerabilities on account of this became more complicated with the sub-prime crisis in the US, where the valuation of the underlying assets, namely, the houses under mortgage, could not be valued in any transparent way.
- The *oligopolistic nature of credit rating agencies* in the US, with three agencies – Standard and Poor, Moody’s and Fitch – dominating the market. This, together with the adoption of sophisticated mathematical models by them that did not allow for human error or human factors such as ‘irrational exuberance’ or pessimism – resulting in herd behaviour in financial markets. The electronic technology that came into vogue has become both an asset and a liability in driving the crisis.
- The growth of hybrid instruments involving a *bundling of securities* that lacked transparency, and the trading of securities that were too rapid for investors to be able to take a mature view of the underlying value.
- *Regulatory failure* in the financial sector – with some important areas associated with globalisation either left unspecified or poorly regulated (such

as trading in derivatives) – and the emergence of regulatory arbitrage.<sup>4</sup> Examples of this include the failure to develop proper procedures for assessment of risk of extending credit or undertaking investment in different types of assets (e.g. loans for housing, or investing in foreign securities).

- The general belief among the regulatees that every law has loopholes, any legislation could be circumvented and that any deemed violation could be settled through minor financial penalties, nurtured a culture of risk-taking in defiance of regulatory regimes.<sup>5</sup>
- *Regulatory capture by major banks*: for example, the development of close ties by bankers and property developers with the ruling political parties in some countries, with the result that the regulatory regimes in place have failed to promote adequate risk-weighted provisioning for loans and investments by financial institutions. Some have argued that the formulation of Basel II standards was much influenced by big multinational banks.<sup>6</sup>
- The nurturing of a false belief that some banks or investment institutions are ‘*too big to fail*’, resulting in inertia and hesitancy by the public authorities and the financial companies to take appropriate steps to minimize risk.
- Hedge funds, that became major players in the financial world, were not subject to regulatory regimes. Their functioning remained obscure, beyond the knowledge of the regulatory authorities.
- Exposure of banks to equity markets and cross-holding of shares by banks, with systemic stability exposed to risk.

### **III Reliance on government and public sector to contain the crisis**

While the above developments point to factors leading to the recent financial and economic turmoil, at the same time, there is evidence that some countries that have relied more on the role of government and the public sector have managed to contain the crisis in a more successful way.

- *The Peoples Republic of China*, assisted by its accumulation of foreign exchange reserves and its large public sector, effected a significant stimulus by way of investment in infrastructure and subsidies to consumers for purchase of consumer durables and the like.
- The experience of *India* points to the value of having a significant presence of publicly-owned commercial banks in warding off – and in containing – the spread and intensity of the crisis, because they were able to act directly to the will of the government and to the Reserve Bank of India (RBI)<sup>7</sup> in an unhesitating way.<sup>8</sup> The public sector, in general, provided a great lever for the government in stabilizing the situation. In India:
  - the objectives of regulation included the stability of the financial system and quality of service to consumers.

- non-bank financial companies (NBFCs), in addition to insurance, pension funds and mutual funds, are regulated. The systemically important NBFCs, defined by size, are more intensely regulated.
  - the Reserve Bank of India uses discretionary powers to prohibit, restrict or permit non-core bank activities by banks.
  - a high-level coordination committee on financial markets under the chairmanship of the RBI, with participation from the Ministry of Finance, and the executive heads of the regulatory authorities for insurance, securities and pensions, is in place. This enabled an effective supervision of the financial system.
  - there is a close scrutiny of benefits and risks of innovative financial products or practices by banks and other financial institutions by the respective regulatory authorities. The RBI, by its unique position in the supervision of the financial architecture, was able to moderate the pace of such innovations – e.g. derivatives – to suit Indian conditions.
  - there is scrutiny by the RBI of the pay of chief executives of banks in the private sector, and non-approval of entry or exit bonuses; bonuses were subject to guidelines.<sup>9</sup>
- *Brazil*: the policy of a bigger role for the state has helped it to withstand the global crisis much better. When credit from abroad dried up at the end of 2008, Banco do Brazil, the biggest state bank, stepped into the breach. Brazil's policy of high reserve requirements also helped in preventing bank failures.<sup>10</sup>
  - The experience of Canada, which has avoided the worst consequences of the crisis, also illustrates the role that governments can play – through such steps as limiting leverage, protecting consumers, and avoiding getting caught in an ideology that denies any need for regulation.<sup>11</sup>

It needs to be recognised that the financial system needs to be monitored closely, and its stability ensured by a balanced and robust public system. A part of the financial system should be in the public sector that is not driven purely by profit motive.

It is also necessary to deal with the axiom or the belief that some banks are 'too big to fail', as any such formal recognition encourages them to take excessive risks, and such situations should not be allowed to arise. Perhaps, banks should not be allowed to grow that big!<sup>12</sup> And if they do, there might be a case for providing for regulation that is big-bank specific, while ensuring that there is no scope for regulatory arbitrage.

In the contemporary world, while there is globalisation of finance, there is no globalisation of regulation. In economic unions that have free trade flows of trade and capital, and have a common currency (e.g. the EU), the choice of policy instruments available at the national level is near zero, leaving individual governments with difficult tasks of management from sudden flights of capital (e.g. Greece).

### **III The need to reposition the public sector and administration, and build trust in government**

In the light of the recent trends and the ongoing economic crisis, it is clear that the world should be 'highly skeptical of the benefits of general and limitless financial liberalization'. And more generally, financial intensity and liberalization are valuable only up to a point and in some markets.<sup>13</sup>

Many societies that have embraced market fundamentalism have witnessed sharp rises in the ratio of profit or rent and a falling share of wages in total income, and rises in the disparity between wages and the executive pay – in other words, a greater inequality in income. This erodes belief in a just society and government.<sup>14</sup> Part of the issue here is the rise of 'the pursuit of profit' as an overarching principle of economic life, and the emergence of predatory self-interest in economic conduct, with the consequent erosion of the underlying values of morality and ethics.

Neglect of action to correct for perceived deficiencies in regulatory regimes, or indeed overlooking violation of legislation in instances where powerful vested interests are involved, could very rapidly end up in a loss of trust in governance<sup>15</sup>.

It should be understood that the task of governmental agencies is not to be passive and react to events as they develop. The task should include detection and anticipation of the crises, and when they occur, act quickly for their speedy resolution.

The growing centralization of power in major corporations and in the executive wings of government – resulting in a feeling of helplessness on the part of the citizen – adds to this loss of belief in a just society. Such a loss can only lead to disorder and undermining of peaceful life.

But how can one restore trust in government? In many societies, there is an implicit belief that a strengthening of public administration through new laws and regulations can set the wrongs right; however, one can argue that the compliance with law is itself based on a certain common set of moral values and traditions<sup>16</sup> – and when these are eroded, it will not be easy to secure compliance to good behaviour by the simple act of promulgation of law and administrative rules alone. Public values – transparency, predictability, and equality before law – need to complement the individual values for achieving good government.

There is, therefore, a need to revisit, redefine and bolster the roles of government and reposition the public sector with a view to provide stability, growth and restore faith in a just society.

As against these developments in the market-led growth processes in the recent period, it is also important to recall that big governments with concentration of political and economic power in a few hands and agencies can lead to loss of freedom, innovation in government and public administration, and poor service delivery. When governments are the monopoly suppliers of services or goods, they often prove to be indifferent suppliers at high cost. There is thus a need for competition, decentralisation of power and a healthy balance between the executive and the legislative wings of government.

#### *Role of civil Society*

In such a framework, in which neither the ‘profit motive’ nor ‘big government’ are the overarching principles of social organization, there might be a place for public-private-people partnerships, with a recognised role for civil society, as is evident from some examples of successes that have won innovation awards from the Secretary-General of the United Nations.<sup>17</sup> The debate should not be conducted in terms of public versus private sectors alone: it should transcend these categories to arrive at new, innovative forms of governance that fully take cognizance of the new polities that we live in.

#### **IV Concluding Remarks**

The global financial and economic crisis has brought into the open the issue of the role of governments and public administration in preventing such crises in the future. The assumption, widely prevalent, that we pause and reset the button, is neither borne out by experience nor safe to rely on. The objectives of regulation should include the assessment of the safety of financial products, the stability of the financial system, including assessment of the risks of unrestricted integration of financial markets domestically and internationally.

The recent experience demonstrates that we do not have such mechanisms. The IMF, the apex body at the global level, to warn and advise on systemic risks associated with financial innovation and capital flows, was conspicuous by its absence. Its voting structure is weighted in favour of big countries that have seen a regulatory capture that fuelled the global crisis. And the other global institutions proved to be too weak to rise to the occasion.

The issue of who would – and how to – fund stimulus packages in times of deep recession also assumes great importance. Countries whose currencies form part of international reserves – e.g. the US Dollar, the Euro, the Yen, etc – have a degree of advantage in this respect; but the ability of other countries to intervene is limited by the need to earn these currencies through export surpluses, which puts a strain on global trade relations in times of recession. A way out is to have a global currency units such as the SDRs which may be issued and allocated to member countries

following a formula that gives weight to GDP and volume of trade of member countries. It is also for consideration whether regional – rather than global – currency units cannot be also created to boost demand for the trade of the respective regions. Such a scheme will provide more opportunities for a greater dispersion of trade creation across the world.

The other issue is who should bear the burden of the rescue packages. Given the systemic importance of banks, and the need to deal with the problem of ‘moral hazard’, there is some value in looking to the commercial banks to fund some of these costs of intervention. In this regard, in the search for new solutions in which the banks share their responsibility, it is interesting that some countries have called for the establishment of a global levy on banks that could be drawn upon by governments in times of crisis in bringing order and stability to markets (e.g. rescue packages).<sup>18</sup> It is also interesting that there is a revived interest in the ‘Tobin Tax’ with a view to reduce volatility in short-term capital flows that can prove to be destabilizing.

The world leaders are in search of new forums – such as the G20 – that reflect the changing weight of countries in the global economy; but they remain consensus building fora, rather than institutions that can act quickly and ensure compliance to new understandings. There is also a feeling among some that the G-20 grouping is a mechanism for co-opting the major developing countries in which the industrial countries predominate. The small states are left out of this emerging new architecture. Perhaps, the smaller states should group themselves into blocs of countries to form economic unions and represent their interests in the global fora. These issues need attention and discussion.

In this context, it is important to recognise the special situation of small states – be they developing or industrial countries. Small states perforce depend more on international trade opportunities; but by virtue of their limited size, they have limited resilience to withstand adversity. The larger states tend to be better placed in this respect. In such circumstances, however robust the national regulatory frameworks are, the smaller states will face greater challenges in withstanding or overcoming global turbulence. There is, therefore, a need to set up special mechanisms to help out smaller states. The G-20 needs to widen its focus to cover the vulnerabilities of small states also.

In the absence of effective action to tackle the present crisis, and restore growth, the trust of the citizen in social order, necessary for peace and good government, is in danger of erosion. That can do more lasting damage than the injury the current economic penury inflicts. The United Nations that represents all the people of the world living in diverse conditions, and with different experiences of the global crisis, is the best forum to widen the debate and take it forward.

## **V Issues for discussion**

In its discussions, CEPA may wish to discuss, among other issues raised in this note, the following:

(a) How can the international system be strengthened to anticipate and avoid systemic risk? Are the current financial and trade institutions at the international level (IMF, World Bank, WTO, BIS) adequately geared to anticipate, warn and contribute to a reduction in systemic risk? How can the UN, that gives equal weight to all nations in its deliberations, play a greater role in this regard?

(b) What steps can national governments take to improve their capacity for preventing systemic risk? And when it occurs, address it quickly?

(c) What steps can be taken at a global and national level to prevent regulatory capture by banks and other financial players in the market?

(d) In a globalised world, many developing countries are at the receiving end of developments that are largely outside their control. What can be done to bring attention and give due weight to the policy decisions and developments in major countries that have a wider global impact? And how can the developing countries and small states be helped to establish mechanisms that can quickly and effectively deal with risks emanating from outside their national domains?

(e) What steps can be taken to strengthen the role of the public sector in effectively dealing with emerging dynamic situations and the risks emanating from national and international developments? What steps can be taken to build the trust of the citizen in public administration in the industrialized and developing countries, in the absence of which societies can descend into disorder and anarchy?

## **Notes**

<sup>1</sup> In writing this note, I have drawn extensively from a seminar on the global economic crisis given by Dr. A. Premchand, former Assistant Director at the IMF, on 16 February at the Administrative Staff College of India, Hyderabad (see Premchand, A., 2010); I am grateful to him for allowing me to draw on his unpublished paper, and for his comments and suggestions on an earlier draft of this note. I have also benefited from the A.M. Khusro Memorial Lecture on 'Financial Sector Regulation in India', delivered by Dr. Y.V. Reddy, former Governor of the Reserve Bank of India, at the Administrative Staff College of India, Hyderabad, on 23 March 2010 (see Reddy, Y.V., 2010). This note was presented to the 9th Meeting of the Committee of Experts on Public Administration of the United Nations at its 9th Meeting in the week of 19 April 2010, New York.

<sup>2</sup> See Premchand, A. (2010).

<sup>3</sup> Ibid.



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- <sup>4</sup> Ibid.; Rangarajan, C (2010).
- <sup>5</sup> Premchand, A. (2010).
- <sup>6</sup> Lall, Ranjit (2009); see also Wood, Duncan (2005).
- <sup>7</sup> Reddy, Y.V. (2010). Under Dr. Reddy's stewardship, the RBI stood firm in insisting on a variable and adequate provisioning of reserves by commercial banks against riskier loans, such as for purchase of houses and real estate.
- <sup>8</sup> In the five years up to 2007-08, India's economic growth rate averaged close to 9 per cent a year; with the onset of the global economic crisis in the second half of 2008-09, the growth rate declined to 6.7 per cent; the decline would have been greater but for the stimulus package implemented by the Government of India. The growth rate for the current year 2009-10, is expected to reach a level of 7 per cent. See Shankar Acharya (2010).
- <sup>9</sup> See Reddy, Y.V. (2010)
- <sup>10</sup> *The Economist* (2010: 39-40).
- <sup>11</sup> Krugman, Paul (2010).
- <sup>12</sup> Reddy, Y.V. (2010).
- <sup>13</sup> Turner, Adair (2010).
- <sup>14</sup> For example, in 1965, an average American chief executive of a company was paid twenty four times the wage of an average worker; by 2007, this ration increased to two hundred seventy five! See Premchand, A. (2010).
- <sup>15</sup> Premchand, A. (2010).
- <sup>16</sup> Ibid.
- <sup>17</sup> For example, the Water and Sanitation Management Organisation (WASMO) from India that won the UNSG's Award in 2009.
- <sup>18</sup> *Financial Times* (2010).

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