10-11 whatnext jun08.qxd 22/5/08 11:19 am Page 10

Nasty, but not a disaster

DAVID KERN LOOKS AT HOW HOPES THAT THE GLOBAL SLOWDOWN WOULD BE RELATIVELY SHORT, AND THAT OTHER REGIONS COULD DECOUPLE FROM THE CONSEQUENCES OF THE US RECESSION, ARE GIVING WAY TO GRIMMER ASSESSMENTS.

The US sub-prime crisis started as a liquidity problem, caused by poor-quality mortgage lending. But the issue has escalated into a major global emergency, because of two main reasons: the scale of the sub-prime losses is much bigger than initially estimated; and modern banking practices, which involve the securitisation of assets and their placement off the balance sheet of the bank originating the loan, have failed to work in the face of mounting losses.

The originate and distribute banking model adds to efficiency, and spreads risks more widely. But once the sub-prime problem highlighted big losses, the credit markets have become paralysed by rumours and fears, since no one knows where poor-quality loans previously sold in the market were being held. Banks are afraid to lend to each other, and the banking system has seized up, threatening the credit flows that are vital to sustaining economic activity.

US-EUROPE POLICY DIVIDE Since the crisis began in August 2007, the major central banks have recognised there is a serious liquidity problem, which has mainly manifested itself in the emergence of a historically large gap between official policy interest rates and the three-month interbank rates at which commercial banks lend to each other. In response, all the central banks have injected ever large amounts of cash into their banking systems. But the central banks have been seriously divided in their attitude to cutting interest rates. *Figure 1* shows movements in official interest rates over the period since December 2006.

The US Federal Reserve has responded forcefully to the crisis and supplemented liquidity injections with aggressive interest rate cuts: from 5.25% in August 2007 to 2% in early May 2008. In contrast, the European Central Bank (ECB) has restricted itself to providing cash, but has so far kept official rates at 4%, their pre-crisis level. This striking policy gap is partly down to the initial impact being more severe in the US. But it also reflects a more determined US effort to counter threats to economic growth, even if this entails accepting temporarily greater risk over inflation.

In the euro zone, growth remained initially more robust than in the US, and the ECB has regarded combating inflationary pressures as its main priority. In the UK, the Bank of England has adopted an intermediate position; unlike the ECB, it has cut interest rates, but much less forcefully than in the US. In Japan, official interest rates are close to zero, and the main impact of the crisis has been to delay any intention of the Bank of Japan to start raising rates towards more normal levels.

THREATS TO GROWTH As the credit crisis has unfolded it has become clear that liquidity is not the only problem. The banking system is also facing a major solvency crisis, resulting from mounting bad debts, worsening pressures on bank capital ratios, and steep falls in house prices, particularly in the US. The measures taken by the central banks have had a degree of success in improving liquidity and restoring calm to the markets. But they have failed to end the crisis, and could not avoid harmful effects spreading from the financial markets to the real economy. The full negative impact on economic growth is still difficult to gauge, but it is clear that the key critical factors are: the size of the sub-prime losses; the scale of the decline in house prices; the extent of the decline in the banks' ability to lend; the damaging effects on jobs and consumer spending; and the effectiveness of policy measures.

GDP growth forecasts have been cut repeatedly since last summer in all the major economies, most notably in the US. But perceptions have changed. A marked 2008 slowdown has been widely expected since the early stages of the crisis, but there have been hopes that the US downturn, though serious, would be relatively short-lived and this would limit the damaging consequences for other regions. However, the initial hope that 2009 would see a return to more normal growth rates has given way to a more sober assessment. Though the global slowdown will not be calamitous, it is likely to last well into 2009, with GDP growth only returning to a normal pace in 2010. The downturn is likely to be U-shaped rather than V-shaped. Another important change is the emergence of a more gloomy assessment of prospects for Europe and Japan, particularly in 2009. *Table 1* shows GDP growth figures for the world's major economies, including forecasts for 2008 and 2009.

Executive summary

- The global credit crisis is entering a new phase, less dramatic but still very dangerous. The financial markets are showing signs of stabilising, but oil prices have risen to unprecedented highs and the dangers remain acute.

Table 1: Annual GDP growth of major economies between 2003 and 2009

	2003	2004	2005	2006	2007	2008	2009
US	2.5%	3.6%	3.1%	2.9%	2.2%	0.9%	1.4%
Japan	1.4%	2.7%	1.9%	2.4%	2.1%	1.3%	1.4%
Euro zone	0.8%	2.1%	1.6%	2.8%	2.6%	1.5%	1.5%
Germany	-0.3%	1.1%	0.8%	2.9%	2.5%	1.6%	1.6%
France	1.1%	2.5%	1.7%	2.0%	1.9%	1.5%	1.5%
Italy	0.0%	1.5%	0.6%	1.8%	1.5%	0.6%	0.7%
Spain	3.1%	3.3%	3.6%	3.9%	3.8%	2.1%	2.0%
UK	2.8%	3.3%	1.8%	2.9%	3.0%	1.7%	1.6%
China	10.0%	10.1%	10.4%	11.6%	11.9%	10.0%	9.6%
India	6.9%	7.9%	9.0%	9.7%	9.2%	7.4%	7.2%

10-11 whatnext jun08.qxd 22/5/08 11:19 am Page 11

Figure 1: Official interest rates since December 2006

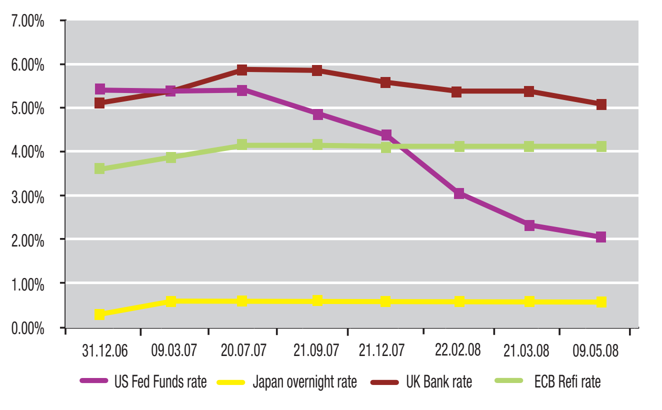
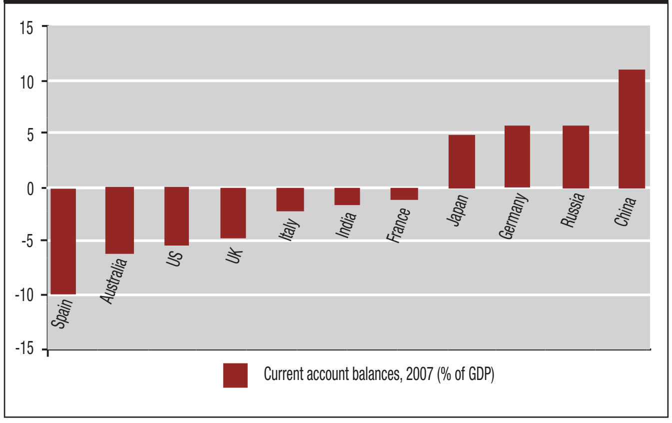


Figure 2: Current account balances, 2007



THE WORLD'S MAJOR REGIONS Until recently, the most acute economic risks have been in the US, as the housing market has plummeted and the US jobs market has shrunk. US house prices have fallen by more than 15% from their recent peak, and US job losses totalled 240,000 in the first three months of 2008. But the US downturn is probably stabilising, in reaction to aggressive counter-measures taken by the Fed and the Bush administration. There are tentative signs that the pace at which house prices are falling may be easing, while the fall in US jobs in April was only 20,000, which was much less than expected. US GDP growth will probably record small quarterly falls in the next few quarters. Any 2009 recovery will be shallower and emerge later than previously predicted. The US outlook is still grim, but the worst will probably soon be over.

In contrast, there are distinct risks that Europe and Japan, which have so far been less exposed than the US to the crisis, may experience a marked slowdown in the next three or four quarters. China, India and other Asian economies will continue to grow relatively strongly in 2008, but at a much slower pace than in 2007.

Greater inflationary risks, mainly resulting from surging food and energy prices, have unquestionably aggravated the problems facing the world economy. Higher inflation, at a time of weakening economic growth, creates the toxic stagflation combination. Higher oil and food prices have squeezed growth, and complicated the jobs of the various central banks, making it more difficult to cut interest rates at the very moment when slowing activity requires policy easing.

INTEREST RATE OUTLOOK The US Fed is clearly in a stronger position than other central banks in its ability to cope with the immediate pressures. Having cut interest rates very sharply since last August, in spite of the risks to inflation, and having been helped by stimulatory tax cuts, the Fed can now afford to move to a less aggressive phase. Fed rates are probably approaching their low point in the present cycle. The markets still expect further modest cuts in US official interest rates this year, but the pace of US monetary easing will become much less forceful. *Table 2* summarises forecasts of movements in official interest rates over the next two years.

Table 2: Official interest rate forecasts

	Actual		Forecast			
	end 07	09.05.08	6-mnth	12-mnth	18-mnth	24-mnth
US Fed Funds	4.25%	2.00%	1.75%	1.75%	2.00%	2.25%
ECB Refi	4.00%	4.00%	3.50%	3.50%	3.50%	3.75%
Japan overnight	0.50%	0.50%	0.50%	0.75%	1.00%	1.50%
UK Bank	5.50%	5.00%	4.50%	4.50%	4.75%	5.00%

In Europe, small cuts are expected only in official interest rates, in response to weaker economic activity. The ECB's reluctance to ease policy in the face of strong inflationary pressures will remain a restraining factor. Euro zone growth would suffer if the ECB maintained a hard line, and the harmful effects could be exacerbated by the strength of the euro. The UK, which is also likely to cut interest rates modestly, should benefit from the weakness of sterling, mainly against the euro. But, unlike the US, the UK will be unable to introduce significant fiscal measures to support growth, because the government is constrained by the poor state of UK public finances.

Global imbalances, reflected in the contrast between huge current account deficits and surpluses, remain a serious global issue. The position in 2007 is shown in *Figure 2*. The huge US deficit remains a major concern, even after its recent significant decline, particularly if the combined effects of the credit crunch and large US interest rate cuts force precipitate falls in the dollar. It is important to note that the UK and Australia are also living with large and persistent deficits. At the other extreme, China, Japan, Russia, and other oil exporters are accumulating large surpluses. Reducing these imbalances is important but painful. *Figure 2* also highlights the internal tensions within the euro zone, given the huge gap between large surpluses in Germany and large deficits in Spain and Italy.

SOBER ASSESSMENTS Hopes that the global slowdown would be relatively short, and that other regions could decouple from the consequences of the US recession, are giving way to grimmer and more sober assessments. The US downturn, while not disastrous, is likely to be nasty and prolonged, extending well into 2009. At a global level, recession is unlikely. But Europe, Japan and even fast-growing Asian economies such as China and India will not be able to escape some of the unpleasant consequences. The best estimate is that the damage to growth will be serious but not disastrous. While extreme outcomes can be envisaged, undue pessimism is unjustified. It is too early for the prophets of doom to declare victory.

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