

Baseline Scenario for 12/15/2008 (9:30am edition)

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Summary

- 1) The world is heading into a severe slump, with declining output in the near term and no clear turnaround in sight.
- 2) Consumers in the US and the nonfinancial corporate sector everywhere are trying to “rebuild their balance sheets,” which means they want to save more.
- 3) Governments have only a limited ability to offset this increase in desired private sector savings through dissaving (i.e., increased budget deficits that result from fiscal stimulus). Even the most prudent governments in industrialized countries did not run sufficiently countercyclical fiscal policy in the boom time and now face balance sheet constraints.
- 4) Compounding these problems is a serious test of the eurozone: financial market pressure on Greece, Ireland and Italy is mounting; Portugal and Spain are also likely to be affected. This will lead to another round of bailouts in Europe, this time for weaker sovereigns in the eurozone. As a result, fiscal policy will be even less countercyclical, i.e., governments will feel the need to attempt precautionary austerity, which amounts to a further increase in savings.
- 5) At the same time, the situation in emerging markets moves towards near-crisis, in which currency collapse and debt default is averted by fiscal austerity. The current IMF strategy is designed to limit the needed degree of contraction, but the IMF cannot raise enough resources to make a difference in global terms – largely because potential creditors do not believe that large borrowers from an augmented Fund would implement responsible policies.
- 6) The global situation is analogous to the problem of Japan in the 1990s, in which corporates tried to repair their balance sheets while consumers continued to save as before. The difference, of course, is that the external sector was able to grow and Japan could run a current account surplus; this does not work at a global level. Global growth prospects are therefore no better than for Japan in the 1990s.
- 7) A rapid return to growth requires more expansionary monetary policy, and in all likelihood this needs to be led by the United States. But the Federal Reserve is still some distance from fully recognizing deflation and, by the time it takes that view and can implement appropriate actions, declining wages and prices will be built into expectations, thus making it much harder to stabilize the housing market and restart growth.
- 8) The push to re-regulate, which is the focus of the G20 intergovernmental process process (with the next summit set for April 2nd), could lead to a potentially dangerous procyclical set of policies that can exacerbate the downturn and prolong the recovery. There is currently nothing on the G20 agenda that will help slow the global decline and start a recovery.
- 9) The most likely outcome is not a V-shaped recovery (which is the current official consensus) or a U-shaped recovery (which is closer to the private sector consensus), but rather an L, in which there is a steep fall and then a struggle to recover.

Introduction: Our Baseline vs. the Current Consensus

The current consensus view (e.g., as seen in the World Bank's Global Economic Prospects) is that we are having a serious downturn, with annualized growth for the 4th quarter in the US at minus 4% or worse, i.e., a rapid fall. But the consensus is that a recovery will be underway by mid-2009 in the US and shortly thereafter in the eurozone. This will help bring up growth in emerging markets and developing countries, so by 2010 global growth will be moving back towards its 2006-2007 rates.

Our baseline view is considerably more negative. While we agree that a rapid fall is underway and the speed of this is unusual, we do not yet see the mechanisms through which a turnaround occurs. In fact, in our baseline view, there is considerably more decline in global output already in the works and, once the situation stabilizes, it is hard to see how a recovery can easily be sustained.

The consensus view focuses on disruptions to the supply of credit and recognizes official attempts to support this supply. In contrast, we emphasize that the crisis of confidence from mid-September has now had profound effects on the demand for credit and its counterpart, desired savings, everywhere in the world.

To explain our position, we first briefly review the background to today's situation. Readers who would like more detail on what happened in and since mid-September should refer to the previous (November 10) edition of our Baseline Scenario. We then review both the current situation and the likely prognosis for policy in major economies and for key categories of countries. While a great deal remains uncertain about economic outcomes, after the US presidential election much of the likely policy mix around the world has become clearer. We conclude by reviewing the prospects for sustained growth and linking the likely vulnerabilities to structural weaknesses in the global system, including both the role played by the financial sector almost everywhere and the way in which countries' financial sectors interact. In the end we come full circle – tomorrow's dangers can be linked directly back to the underlying causes of today's crisis.

Background

We are in a severe "credit crisis," but one that is frequently misunderstood in four ways.

1. While the US housing bubble played a role in the formation of the crisis and continued housing problems remain an issue, the boom was and the bust is much broader. This was a synchronized debt-financed global boom, facilitated by flows of capital around the world.
2. The boom exacerbated financial system vulnerability everywhere. But the crisis in the current form was not inevitable. The severity of today's crisis is a direct result of the failure to bail out Lehman and the way in which AIG was "saved" – so that senior creditors took large losses and confidence in the credit system was shaken much more broadly.
3. The initial problem, from mid-September 2008, was a fall in the supply of credit. But this does not mean that official support for credit supply will turn the situation

around. Now the crisis has affected the demand side – people and firms want to pay down their debts and increase their precautionary savings.

4. There is no “right” level of debt, so we don’t know where “deleveraging” (i.e., the fall in demand for and supply of credit) will end. Debt could stabilize where we are now or it could be much lower. Leverage levels are very hard for policy to affect directly, as they result from millions of decentralized decisions about how much people to borrow. Anyone with high levels of debt in any market economy is now re-evaluating how much debt is reasonable for the medium-term.

The Situation Today

United States

Households did not save much since the mid-1990s and reduced their savings further this decade, in part because of the increase in house prices; this was the counterpart of the large increase in the US current account deficit. Desired household saving is now increasing. The main dynamic is a fall in credit demand rather than constraints on credit supply in the US.

The US corporate sector is in better shape but, faced with disruptions of the last three months, is also seeking to pay down debt and conserve cash. Even entities with deep pockets, strong balance sheets and long investment horizons (e.g., universities, private equity) are cutting back on spending and trying to strengthen their balance sheets.

There are constraints on all three main potential policy responses: fiscal, financial, and monetary.

First, a substantial fiscal stimulus has already been pre-announced by the incoming Obama administration, and this will have broad support in the next Congress. If the stimulus comes in (over 2 years) closer to \$500bn than \$1 trillion, this may be seen as a disappointment relative to current expectations.

The constraint, of course, is the US balance sheet. The US balance sheet is strong relative to most other industrialized countries – private sector holdings of government debt are close to 40% of GDP. But the US authorities also have to worry about increasing Social Security and government medical-related payments in the medium term, and so are reluctant to accumulate too much debt. The underlying problem is that fiscal policy was not sufficiently counter-cyclical during the boom. The federal fiscal stimulus will be helpful, but it will not be enough to prevent a substantial decline or quickly turn around the economy.

Second, financial sector policy has not been encouraging. Dramatic bank recapitalization is off the table, at least for the time being, because this would imply effective nationalization, which is not appealing to Wall Street. The original TARP terms from mid-October are no longer available, as they were very generous to banks and there is some backlash against bailouts. Also, the latest Citigroup bailout (from mid-November) is not scalable to the entire financial system as this was an even worse deal for the taxpayer.

Policies that would directly address the financing of housing are appealing and could help at the margin. But this approach seems unlikely to scale up politically in such a way as to make a macroeconomic difference. This route will take a long time and many modified mortgages will also become delinquent.

Third, monetary policy can still make a difference, particularly as we risk entering a deflationary spiral with falling prices and downward pressure on nominal wages. On December 12th, 2008, the inflation swap market implied minus 0.5% average annual inflation for the next five years. Deflation is not yet completely entrenched - over a 30 year horizon, the implied average annual inflation rate is 1.75% - so it is still possible to turn the situation around. However, the dominant view at the Fed remains that deflation is not yet the main issue, and there is no internal consensus in favor of printing money (or focusing on increasing the monetary base).

Generating positive inflation in this environment is not easy. One way to deal with this would be to talk down the dollar. The fact that this would feed into inflation is not a danger but a help in this context. Unfortunately, this would be seen as too much of a break from the tradition of a “strong dollar” and it would likely upset both Wall Street and US allies. Ultimately, probably later in 2009 (and definitely by early 2010), the US will move to a more expansionary monetary policy and manage to generate inflation. This will weaken the dollar and put pressure on other countries to follow suit – expansionary monetary policy is infectious in a way that expansionary fiscal policy is not.

Eurozone

There is growing pressure on some of the weaker sovereigns that belong to the euro currency union. Greece faces the most immediate problems, as demonstrated both by widening credit default swap spreads and – over the past few days – increasing spreads of Greek bonds over German government bonds. The cost of servicing Greek government debt is thus rising at the same time as Greece has to roll over debt worth around 20 percent of GDP in the coming year.

Greece has a debt-to-GDP ratio that is close to 100 percent, so there is real risk of default. In our baseline view, Greece receives a fairly generous bailout from other eurozone countries (and probably from the EU). This, however, does not come early enough to prevent problems from spreading to Ireland and other smaller countries (which then also need to implement fiscal austerity or to receive support). Italy is also likely to come under pressure, due to its high debt levels, and here there will be no way other than austerity. With or without a bailout, Greece and other weaker euro sovereigns will need to implement fiscal austerity.

The net result is less fiscal stimulus than would otherwise be possible, and in fact there is a move to austerity in among stronger euro sovereigns as a signal. Governments will therefore struggle to dissave enough to offset the increase in private sector savings.

Monetary policy will be slow to respond. The European Central Bank decision-making process seeks consensus and some key members are still more worried about inflation down the road than deflation today. Eventually the ECB will catch up, but not before there has been considerable further slowing in the eurozone.

The current official consensus is that the eurozone will start to recover in mid-2009 and be well on its way to achieving potential growth rates again by early 2010. This seems quite implausible as a baseline view.

United Kingdom

Over the last month, the Bank of England has moved to a pro-inflation policy, with big interest rate cuts and statements that are tending to depreciate the pound. The inflation swap market implies annual average inflation in the UK of 0.8% per year over the next five years. This fits with the fiscal stimulus of the British government, and presumably amounts to effectively inflating away debts.

Still, the UK faces a major problem with falling house prices and a decline in the financial sector. We could think of the UK as a place with one primary export: financial services. This sector has just suffered a major terms of trade shock and will contract globally, so first-order macroeconomic adjustment in the UK is essential. Inflation will be used to cushion the necessary real adjustment.

Japan

The yen has appreciated as carry trades have unwound, so people no longer borrow in yen to invest elsewhere. Corporates are likely to want to strengthen their balance sheets further. Households are unlikely to go on a spending spree.

The government's balance sheet is weak, but it is funded domestically (in yen, willingly bought by households), so there is room for further fiscal expansion. However, this is unlikely to come quickly.

The ability of the Japanese central bank to create inflation has proved limited. Once deflationary expectations are established, these are hard to break. In the inflation swap market (on 12/12/08), the average annual rate of inflation expected over five years is minus 2.4%, and an astonishing minus 1.0% over 30 years.

Emerging markets

The major increase in savings by China over the past 10 years was primarily due to high profits in the corporate sector. This was the counterpart to the current account. Chinese growth now seems likely to slow sharply.

Pressure on other emerging markets will intensify after Ecuador's default. Some countries will be willing to go early to the IMF, but for others the fear of a potential stigma effect will lead them to prefer fiscal austerity (and perhaps even contractionary monetary policy) without IMF involvement.

The IMF will be helpful in smaller emerging markets, such as East-Central Europe. But it doesn't have (and won't receive) enough funding to make a difference for large emerging markets, whose problems are due to their own policy mix, particularly allowing the private sector to take on large debts in dollars. Emerging markets will also have no appetite for massive loans.

Larger emerging markets will not suffer collapse, but they will have increased (attempted) savings and, as a result, will experience slowdowns. The temptation for competitive devaluation will grow over time; adjusting the exchange rate is easier if there is no IMF program.

But emerging markets cannot grow out of the recession through exports unless there is a strong recovery in the US or the eurozone or both, which is unlikely. Many emerging markets are particularly hard hit by the fall in commodity prices, which could be exacerbated by expected US policies to reduce oil consumption. Commodity prices are likely to fall further.

Political risks in China and other emerging markets create further downside risks. In our baseline, we assume no serious domestic or international disruptions in this regard.

Looking Forward: Structure of the System

Potential for Revising Expectations Upwards

The last few months have shown the importance of confidence. The severity of the current downturn was largely caused by the climate of fear that was triggered by the Lehman bankruptcy and that has yet to dissipate. In a downturn, poor policy choices have the procyclical effect of decreasing confidence further.

Conversely, increased optimism could itself have a significant stimulative effect on the world economy, like the announcement of President-Elect Obama's economic team - which contained no surprises - boosted spirits in the US stock market. While attitudes today are resoundingly negative, in virtually every sector and every country, there is a strong human tendency to want to believe in positive stories and to think that things have improved with a "structural break." Arguably, the US recovered from the collapse of the technology bubble in 2000-2001 by convincing itself that housing prices would rise forever.

There is always the potential for another boom. This is especially true because it is politically difficult to impose regulation to dampen growth; central banks have shown little appetite to take away the famous punch bowl (see Alan Greenspan in particular); and boom environments create rational incentives for the private sector to play along in inflating the bubble of the moment (see Andrew Lo's testimony to Congress, excerpted here [<http://baselinescenario.com/2008/11/16/systemic-risk-hedge-funds-financial-regulation/>]).

However, the answer to a recession should not be to seek out the next bubble. The only real way to protect a national economy in the face of systemic financial problems is with a sufficiently strong government balance sheet (i.e., low debt relative to the government's ability to raise taxes). This requires counter-cyclical fiscal policy during a boom, which is always politically difficult. However, this implies less room for fiscal stimulus now, or a need to put in place measures now that will compensate for the stimulus once the economy has recovered.

What's the real structural problem?

In order to create the conditions for long-term economic health, we need to identify the real structural problem that created the current situation. It wasn't a particular set of payments imbalances (read: US-China), as these can and will change (which does not excuse policymakers who refused to address this issue). It wasn't the failure of a particular set of domestic regulators, as regulatory challenges and responses change over time (which doesn't excuse the specific regulators).

The underlying problem was that, after the 1980s, the "Great Moderation" of volatility in industrialized countries created the conditions under which finance became larger relative to GDP and credit could grow rapidly in any boom. In addition, globalization allowed banks to become big relative to the countries in which they are based (with Iceland as an extreme example). Financial development, while often beneficial, brings risks as well.

The global economic growth of the last several years was in reality a global, debt-financed boom, with self-fulfilling characteristics – i.e., it could have gone on for many years or it could have collapsed earlier. The US housing bubble was inflated by global capital flows, but bubbles can occur in a closed economy (as shown by experiments [<http://baselinescenario.com/2008/12/07/financial-crisis-bubbles-causes-psychology/>]). The European financial bubble, including massive lending to Eastern Europe and Latin America, occurred with zero net capital flows (the eurozone had a current account roughly in balance). China's export-driven manufacturing sector had a bubble of its own, in its case with net capital outflow (a current account surplus).

But these regional bubbles were amplified and connected by a global financial system that allowed capital to flow easily around the world. We are not saying that global capital flows are a bad thing; ordinarily, by delivering capital to the places where it is most useful, they promote economic growth, in particular in the developing world. But the global system also allows bubbles to feed on money raised from anywhere in the world, exacerbating global systemic risks. When billions of dollars are flowing from the richest countries in the world to Iceland, a country of 320,000 people, chasing high rates of interest, the risks of a downturn are magnified, for the people of Iceland in particular .

The prevalence of debt in the global boom was also a major contributing factor to today's recession (although major disruptions could also arise from the busting of pure equity-financed booms). Debt introduces discontinuities on the downside: instead of simply becoming losing money, companies with high debt levels go bankrupt in hard times. Lehman, AIG, and now GM all created systemic risks to the US and global economies

because one default can trigger a series of defaults among other companies - and simply the fear of those dominos falling can have systemic effects. Similarly, emerging market defaults can have systemic effects by spreading fear and causing investors to pull out of unrelated by similarly situated countries (and causing speculators to bet against their currencies and stock markets).

Ideally, global economic growth requires a rebalancing away from the financial sector and toward non-financial industries such as manufacturing, retail, and health care (for an expansion of this argument, see the op ed available through [<http://baselinescenario.com/2008/11/11/obama-economic-strateg/>]). Especially in advanced economies such as the US and the UK, the financial sector has accounted for an unsustainable share of corporate profits and profit growth. However, the financial sector, despite the experiences of the last year, is still powerful enough to resist significant structural reform. While this will not prevent a return to economic growth, it will maintain all of the risks that led to the current situation - in particular, the risk of synchronized booms and busts around the world.

Further reading

Background material

Previous edition of Baseline Scenario: <http://baselinescenario.com/2008/11/10/baseline-scenario-111008/>

Beginners section: <http://baselinescenario.com/financial-crisis-for-beginners/>

Causes of the crisis: <http://baselinescenario.com/category/causes/>

MIT classes on the global crisis, including webcasts:

<http://baselinescenario.com/category/classroom/>

More details on current topics

Auto bailouts: <http://baselinescenario.com/tag/auto-industry/>

Global fiscal stimulus: <http://baselinescenario.com/2008/12/08/global-fiscal-stimulus-will-this-save-weaker-eurozone-countries/>

Latest on official forecasts: <http://baselinescenario.com/2008/12/11/forecasting-the-official-forecasts/>

Citigroup bailout (the second round):

<http://baselinescenario.com/2008/11/27/international-implications-of-the-citigroup-bailout/> and <http://baselinescenario.com/2008/11/24/citigroup-bailout-weak-arbitrary-incomprehensible/>

As it happened

First edition of Baseline Scenario (September 29, 2008):

<http://baselinescenario.com/2008/09/29/the-baseline-scenario-first-edition/>

Testimony to Joint Economic Committee (October 30, 2008):

<http://baselinescenario.com/2008/10/30/testimony-before-joint-economic-committee-today/>

“The Next World War? It Could Be Financial” (October 11, 2008):

<http://baselinescenario.com/2008/10/12/next-up-emerging-markets/>

Pressure on emerging markets (October 12, 2008):

<http://baselinescenario.com/2008/10/12/next-up-emerging-markets/>

Pressure on the eurozone (October 24, 2008):

<http://baselinescenario.com/2008/10/24/eurozone-default-risk/>

Bank recapitalization options (November 25, 2008):

<http://baselinescenario.com/2008/11/25/bank-recapitalization-options-and-recommendation-after-citigroup-bailout/>