

The global downturn: how deep, how long?

February 2009

Contacts:

Robert Blotevogel
Group Economics
+44 131 626 3953

robert.blotevogel@rbs.co.uk

Robert Gardner
Group Economics
+44 131 626 3697

robert.a.gardner@rbs.co.uk

[Group Economics Internet](#)

Chart 1: Capital inflows into US and UK as share of GDP (in %)

Source: Datastream, BEA

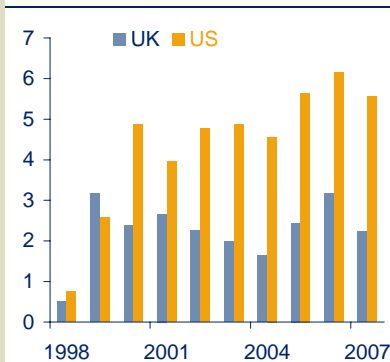


Chart 2: House prices in the highly leverage countries

Source: Datastream, (Index, 2001 = 100);

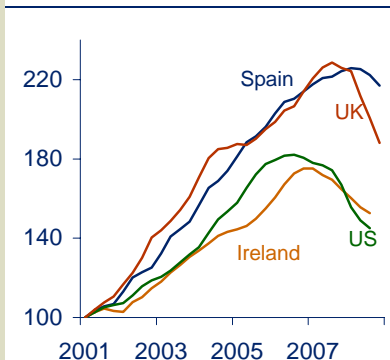
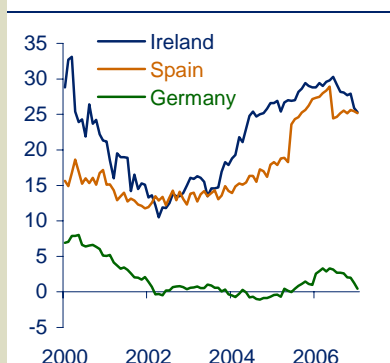


Chart 3: Private sector credit growth (in %, y/y)

Source: Datastream



If the history of financial crises offers any clues about the future of the global economy, the news isn't good. Recessions following financial crises tend to be deeper and more protracted than those without. The synchronised nature of the downswing, the painful structural adjustments that are required and the threat of deflation all pose significant downside risks to an already challenging outlook.

Policymakers are displaying unprecedented activism to ensure that the world economy avoids a depression-style scenario. Adopted measures include the slashing of interest rates, recapitalisation of the banking sector, government spending programmes and tax cuts. And central banks have started to target market interest rates (instead of just the overnight rate), sometimes with the help of newly printed money.

Resolving global imbalances will be part of the recovery. Highly leveraged countries – the UK, US, Ireland and Spain – will become less reliant on debt-financed consumption, housing and financial services, and more on export industries. The surplus countries that have relied heavily on exports to drive growth – Germany, China and Japan – will see a shift towards domestic demand, particularly household spending. The world cannot avoid these painful adjustments, but policy can smooth the transition.

History repeating itself?

Historically, financial crises have been remarkably similar, both in developing and industrialised economies. Phenomena that are almost always present in the run-up include: large capital inflows, booming credit expansion, asset price bubbles and a rapidly growing financial sector. By these criteria, the highly leveraged countries appeared vulnerable for a long time.

The US and the UK (Chart 1), as well as Ireland and Spain all saw record capital inflows, which helped to finance rising consumer spending. These inflows provided funds to their banking systems, which in turn spurred lending. Foreign capital made up for the shortage of domestic savings (as seen by the growing gap between bank lending and domestic deposits in those economies). Rapid credit growth boosted asset prices, with average house prices in these four countries doubling in the six years to 2007 (Chart 2), while their equity prices took just four years to achieve the same feat. (It is no accident that Germany, a country without a credit boom (Chart 3), saw no significant house price appreciation). The share of financial services in economic activity increased sharply in Ireland (from 7% to 10%) and the UK (from 5% to 8%) in this decade.

Financial downturns tend to be more severe

Financial crises are not as unusual as commonly thought. Since the early 1980s, we have seen a number of major crises including: the Latin American debt crisis, US Savings and Loans, the bursting of the Japanese asset price bubble, the Asian financial crisis, the Russian and Argentinean sovereign defaults and the collapse of the Long-Term Capital Management hedge fund, which sent shockwaves across the global financial system.

Chart 4: Standard vs. financial crisis recessions

Source: IMF, Reinhart and Rogoff (2008)

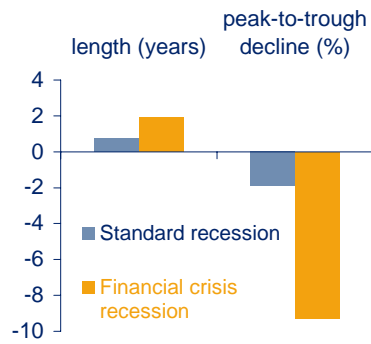


Chart 5: US and UK household savings ratio

Source: Datastream

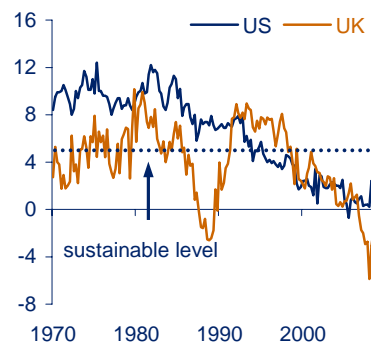


Chart 6: Net % of investors thinking corporate balance sheets are under-leveraged

Source: Merrill Lynch Fund Managers Survey

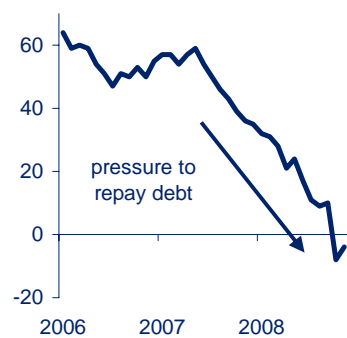


Chart 7: US 5-year inflation expectations (in %)

Source: Datastream



The global downturn: how deep, how long?

Downturns in the aftermath of a financial crisis tend to be more severe than other types of recession (Chart 4). From peak-to-trough, activity declines by more than 9%, compared to c2% for a 'normal' recession. Unemployment rises by over seven percentage points. Unsurprisingly, financial crisis recessions are more protracted too. Output falls for two years on average (in contrast to nine months for a 'standard' recession), while unemployment takes four years to peak. House and equity prices collapse by 35% and 55%, respectively (after adjusting for inflation), and don't recover for four years after the start of their plunge. Government finances also deteriorate sharply, with the stock of outstanding government debt almost doubling.

Against this backdrop, it is particularly worrying that the current financial crisis is without parallel in terms of breadth and depth. Even countries that largely avoided the direct impact of the financial crisis won't escape unscathed. The 'surplus countries', like Japan, Germany, China and many other emerging economies with high saving rates and trade surpluses, are seeing sharp slowdowns. They are suffering from their reliance on external demand to drive growth, as their major trade partners are in recession.

Isn't this time different?

The short answer is 'yes'. Unfortunately, there are a number of factors that could threaten an even sharper downturn:

Fully synchronised. As disastrous as national financial crisis have been in the past, all but the Great Depression occurred at a time when the rest of the world was doing relatively well economically. It's different this time. All developed economies are expected to contract, and growth in emerging markets is also decelerating swiftly. A *worldwide* downturn means there is little scope for exchange rate depreciation that would allow economies to export their way out of trouble – traditionally one of the most potent mechanisms of recovery for individual economies.

De-leveraging. The private sector in the highly leveraged economies will have to reduce debt. Households in the US and the UK are already moving towards financial consolidation, spending less and saving more. But the adjustment will be painful. If saving ratios in the US and UK were to revert to their long-term averages (c.5%) in one year (Chart 5), it would shave 3-5 percentage points off GDP growth in both economies. There is also a danger that they overshoot. Corporates in the UK and parts of the Eurozone have debt burdens close to the highs seen after the collapse of the IT bubble in 2002, and are now under investor pressure to reduce debt (Chart 6). In 2002, the response was sharp retrenchment in business investment – a similar reaction looks odds on this time.

Deflation risks. Global inflation is expected to fall to very low levels, even dipping into negative territory in a number of major economies. Given the pervasive economic weakness, there is a risk that this could turn into deflation – a *sustained* fall in the *general* price level. Deflation is dangerous for two reasons. First, it encourages people and firms to postpone big-ticket purchases. Second, when prices and wages fall, the *real value* of outstanding debt rises, putting an additional burden on borrowers. The aggregate effect would be to choke demand, increase default rates and further shock the financial system. The threat looks most serious in the US, where market-based gauges of expected inflation have plummeted recently (Chart 7). And while the risk of deflation is an old one in Japan, it cannot be completely discounted in the UK and Eurozone.

Why no depression?

There are mitigating factors that suggest the downturn in the major economies will not be as deep as the 'average' financial crisis (with a 9% peak-to-trough decline).

The 'average' is skewed by emerging markets' experience. Financial crises tend to have more serious repercussions in developing economies. The peak-to-trough output decline in South Korea and Indonesia in the wake of the Asian Financial crisis was 9% and 16%, respectively. Similarly, Argentina saw a 17% contraction during its crisis in 2001. In contrast, Sweden in the 1990s, the most recent systemic banking crisis in a developed

Chart 8: The policy response has been aggressive (interest rates, in %)

Source: Datastream

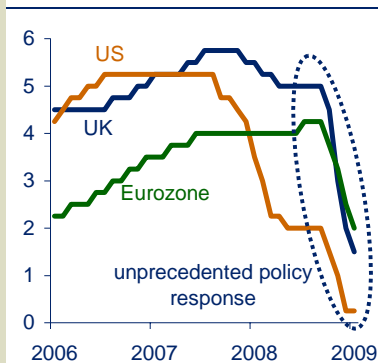
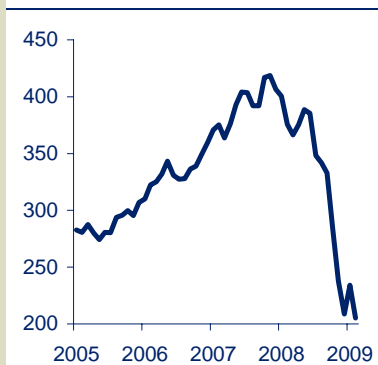


Chart 9: Global equity markets down sharply (MSCI World Index)

Source: Datastream



economy, saw a 6% output loss. This partly reflects the fact that automatic stabilisers are more effective in developed economies. Government spending increases and the tax burden falls as the economy slows, smoothing the ups and downs of the business cycle. Financial crises in emerging markets have often coincided with currency crises, which wreak havoc on corporate balance sheets, as firms are often reliant on foreign capital.

Policy activism is the main reason for hope. The policy response has been, and should remain, aggressive (Chart 8). Governments have injected fresh capital into the banking sector, and announced big tax cuts and infrastructure investments to boost government spending. Central banks have cut interest rates to generational lows, and provided massive amounts of liquidity for the financial sector. As short-term interest rates approach zero, policymakers are beginning to follow the US Federal Reserve's lead in adopting unorthodox measures, like intervening directly in credit markets (to find out more please see our paper [Policymakers: running out of ammunition?](#)).

Where do we go from here?

Policy can only smooth the necessary structural adjustments. There is no doubt that the global downturn will be severe. We expect all the major industrialised economies to contract in 2009 for the first time in the post-war period, with some also seeing activity fall through much of 2010. Recovery is likely to be gradual thereafter. In the UK, leading indicators suggest that the peak-to-trough decline in activity will be twice as large as in the 1990s recession, and almost as deep as the early 1980s downturn. Labour markets typically lag changes in output – unemployment will probably take two years to peak.

Asset prices, on the other hand, are probably closer to their troughs. Average house prices in the UK and the US are already c25% below their peak. As a result, affordability measures have improved significantly, even approaching all-time highs in the US. Spanish and Irish house prices are also falling rapidly. The same is true for stock markets. The MSCI World Index – a good proxy for global equity prices – has already receded c50% from its highs (Chart 9). Judging from past episodes of economic hardship, equities are likely to start their recovery some time before the real economy turns the corner. But there is still some way left to go before real estate markets reach a bottom.

Adjusting to a new pattern of global growth

A number of sectors will be on the wrong end of structural adjustments. In highly leveraged countries like the UK, a key priority will be repairing household balance sheets. This suggests it's going to be a difficult period for providers of non-discretionary goods and services for some time (especially big ticket items). Falling house prices point to a shake-out in construction - especially in countries like Ireland and Spain where the sector swelled to as much as 10% of output. Financial services, the eye of the current global storm, are also likely to account for a smaller share of the economy going forward.

In the short-term, less-cyclical sectors like education, healthcare and utilities will fare better, but are unlikely to be the main engine of the recovery, when it comes. Knowledge-intensive manufacturing is likely to gain in importance as resources move into more export-oriented industries.

'Surplus countries' will see changes too. Global trade is already slowing sharply, which will severely dent growth in economies like Germany, China and Japan (as well as the major commodity producers) that relied heavily on exports. Policymakers are likely to try to re-position their economies to rely more on domestic demand. If successful, sectors that cater to this trend, such as retail, transport and services, will be well placed.

But it is notoriously difficult to engineer this shift quickly, especially when growth is slowing, prompting households to pull-back rather than step-up their spending. For this reason, it may be the public sector that has to do most of the heavy lifting in the short-term. Scope for governments to ramp up spending is highest in emerging markets with solid public finances (like China). Infrastructure is likely to be at the forefront of their efforts, delivering a short-term boost to activity, as well as enhancing long-term growth prospects.