The Macro-economy and the Global Financial Crisis

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Global economic outlook

In past year, global economy affected by three main factors:
- global crisis in financial markets
- major corrections in housing markets
- surge in commodity prices

Collective impact - marked slowdown in economic activity

Risk of severe impact on real economy due to crisis in global financial system
Global economic outlook

- World economy at best on brink of recession
- GDP growth down across the board:
  - global 3%
  - advanced economies 1%
  - US 0.4%, Japan 0.9%, Euro area 0.6%
  - emerging economies 6.5%

Source: IMF
Global economic outlook

- Global deceleration also accompanied by inflation:
  - global 6%
  - advanced economies 4.25%
  - US 4.5%, Euro area 3.9%, Japan 2%
  - emerging economies 8.25%

- Monetary policy dilemma partly eased by recent falls in commodity prices
Global economic outlook

- Key global economic imbalances remain
- Weakening of US growth and depreciation of $ have helped lower US trade deficit to 5% of GDP
- Chinese RMB continues to appreciate modestly, but China’s trade surplus remains above 10% of GDP - RMB still undervalued
- If $ remains world’s reserve currency, US able to underwrite its foreign debt
- Recent appreciation of $ and yen partly result of lower interest rates compared to Euro area
Global economic outlook

Nominal Effective Exchange Rate
(index, 2000 = 100)

- United States
- Euro area
- Japan

2000 01 02 03 04 05 06 07 08
Global financial stability

What is nature of financial crisis?

“...The details can be insanely complex, but the basics are fairly simple. The bursting of the housing bubble has led to large losses for anyone who bought assets backed by mortgage payments; these losses have left many financial institutions with too much debt and too little capital to provide credit the economy needs; troubled financial institutions have tried to meet their debts and increase their capital by selling assets, but this has driven down asset prices, reducing their capital even further...”


Deleveraging has accelerated and become much more disorderly in past two months

Adverse feedback loop between financial system and global economy
Global financial stability

Emerging Market Risks

RISKS

Credit Risks

Closer to center: less risk/tighter conditions

Macroeconomic Risks

Market/Liquidity Risks

Monetary and Financial Conditions

Risk Appetite

10/07
4/08
10/08

Source: IMF
Global financial stability

- Increased macroeconomic risks:
  - growth expectations lower due to credit constraints

- Tighter monetary/financial conditions:
  - deleveraging by financial institutions curtailing credit

- Increased credit risks:
  - systemic risks rising due to credit deterioration

- Increased market/liquidity risks:
  - pressure of asset sales by financial institutions

- Reduced appetite for risk:
  - fund managers becoming more risk averse

- Deepening risks for emerging markets:
  - intensification of capital outflows/likelihood of debt default
The default cycle: bad to worse

- US households under pressure from falling net worth and tighter credit
- Falling house prices and slowing economy weakening prime mortgages
- Deterioration in consumer loans
- Weakening in commercial real-estate loans
- Pressure on leveraged, and small/medium sized firms
- More write-downs ahead – IMF forecasting $1.4 trillion on US-originated debt ($760 billion so far)
What has driven crisis?

- Modern finance resulted in *securitization* of loans which were repackaged and sold
- Demand for complex mortgage securities resulted in loosening of lending standards, driving up house prices
- Markets underestimated impact of financial innovations on house price boom/bust
- Unsustainable growth in household debt
- Fall in prices has had significant “wealth effect”
More instability?

- In theory financial innovations should spread risk, increase financial sector resilience and reduce effect of shocks
- Critics argue modern finance is pro-cyclical
- Uncertainty about scale of risks and who held them has crippled liquidity
- Economy is now less resistant to shocks
- IMF research shows impact of financial shocks has been larger in countries with more sophisticated financial markets
Central bankers not innocent

- Missed scale of risks being built up in “shadow” banking system – hands-off by Greenspan

- Federal Reserve - ignored bubbles, but slashed interest rates when they burst:
  
  (i) 2002/3, loosened rates too much fearing Japanese-style deflation
  
  (ii) 2004/6, did not tighten rates up enough
  
  (iii) 2008, lowered rate to 2% to halt panic in markets

- (i) and (ii), fuelled housing bubble, while (iii) aggravated commodity-price surge
How to handle crisis?

- Piecemeal interventions prior to October 2008 did not address widespread nature of problem

- “...History teaches an important lesson...big banking crises are ultimately solved by throwing in large dollops of public money, and that early and decisive action, whether to recapitalize banks or take troubled debts, can minimize the cost to the taxpayer, and the damage to the economy...” (The Economist, “When Fortune Frowned”, October 9, 2008)

- British bank bailout and US Troubled Asset Relief Program (TARP) belated recognition
How to handle crisis?

Earlier financial crises suggest 5 principles:

1. Comprehensive, timely and clearly communicated measures
2. Consistent/coherent set of policies across countries
3. Rapid response based on early detection of strains
4. Assure interventions are temporary and taxpayer interests protected
5. Medium-term objective of more sound, competitive and efficient financial system
How to handle crisis?

- Actions needed to deal with three interrelated areas of deleveraging:

  1. Insufficient capital – banks require strengthening of their capital ratios (IMF - $675 billion)

  2. Assets – public sector balance sheets should be used to prevent “fire-sale” liquidations of private sector balance sheets

  3. Funding – explore ways of helping institutions relying on wholesale funding, especially cross-border markets

  4. Deposit insurance – expansion best undertaken in coordinated fashion across countries
To regulate or not to regulate?

- Much debate over extent to which financial system now requires further regulation

- *De minimis* need to deal with excessive and excessively pro-cyclical leverage – rethink rules on banks’ capital ratios

- Improve complicated, decentralized and overlapping system of federal and state regulation

- More transparency required in “shadow” banking system

- A financial products safety commission that allows banks to buy and sell “safe” financial products
For further information:

- International Monetary Fund, “World Economic Outlook”, October 2008


- The Economist – Debate between Myron Scholes and Joseph Stiglitz, October 2008