The Global Financial Crisis - Any Progress?

Ian Sheldon

Andersons Professor of International Trade

sheldon.1@osu.edu

THE OHIO STATE UNIVERSITY
DEPARTMENT OF AGRICULTURAL, ENVIRONMENTAL, AND DEVELOPMENT ECONOMICS

Green shoots?

- Sense economic crisis may be easing:
  - major stock markets have risen
  - slump in global manufacturing easing
  - housing markets showing some signs of life
  - investor confidence turning positive
- Optimism may be a trap:
  - possibly misplaced
  - could generate policymaker complacency

Markets – ahead of the curve?

- Should not read too much into daily share price movements
- Investors see profits before any real evidence of turnaround
- History shows rallies often fizzle out

A global inventory-cycle?

- Slump in manufacturing due to global adjustment of inventories over past six months
- Once firms have run down their inventories, will start producing again, easing recession
- Emphasis on inventories ignores two factors:
  - It is a balance-sheet recession precipitated by financial crisis – recovery may be weak
  - Recession is synchronized globally – so recovery may take longer

What will poison economy longer?

- Banking crisis and deleveraging in bubble economies of US and Britain
- US bank stress tests have produced credible estimate of losses ($600 billion), but toxic assets still on their balance sheets
- Tighter credit/asset prices squeezing demand
- Excessive consumer borrowing exposed - US household savings rate has jumped to 4%
- Unemployment/bankruptcies reinforcing trend

The slump is global

- Several emerging economies have suffered from large decline in cross-border capital flows
- World economy in steeper decline than at onset of Great Depression – global output forecast to decline by -1.3% in 2009
- 2010 GDP growth forecasts not optimistic: world (1.9%), advanced economies, (0.0%), emerging economies (4.0%) (*IMF*, April 2009)
- Collapse countered with ambitious policy response - monetary, fiscal and bank bailouts

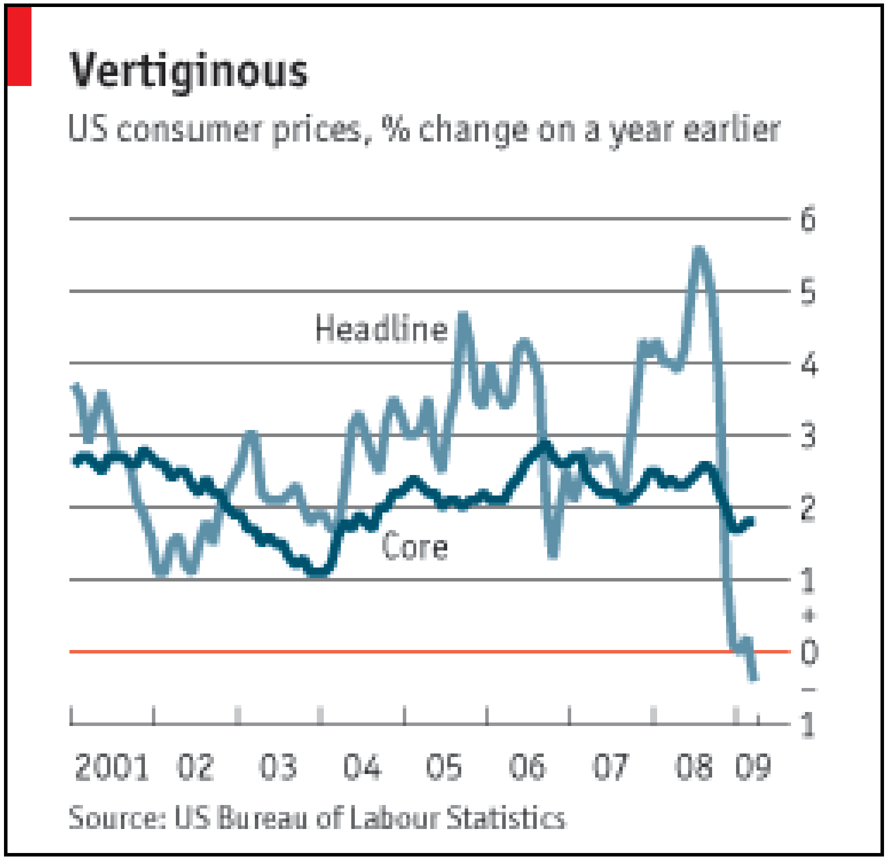
Replacing government demand?

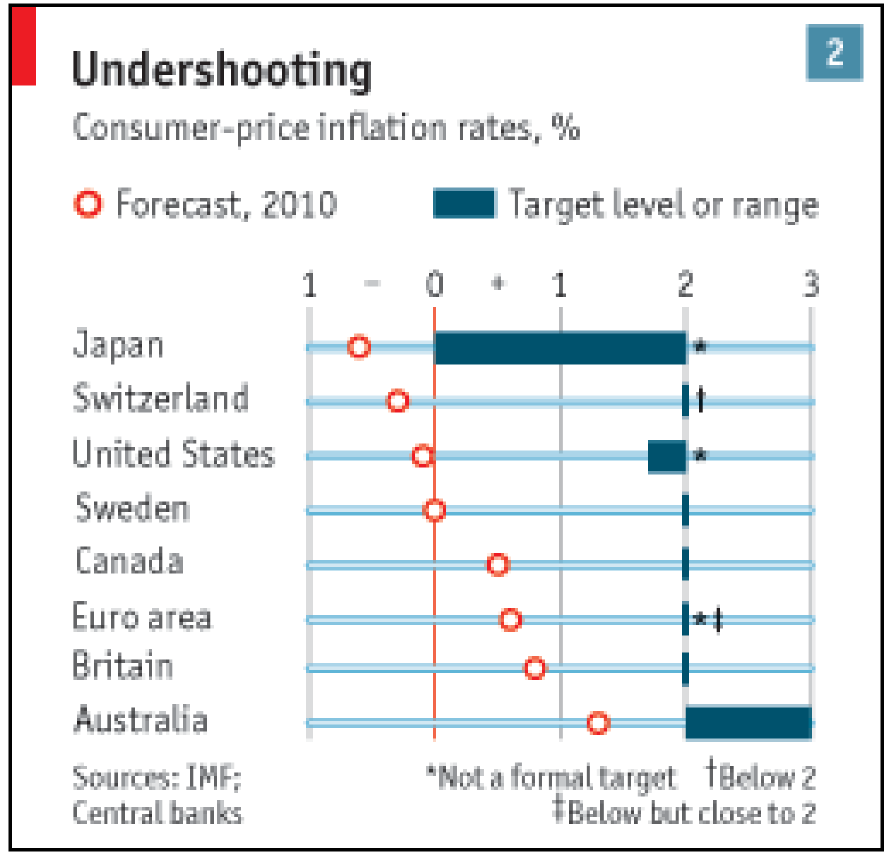
- Depression showed how damaging not reacting can be – but not known whether scale of current policy intervention will work
- Real recovery depends on government demand being supplanted by private spending
- Where will it come from?
  - (a) US, private-sector still deleveraging
  - (b) UK balance-sheet adjustment even more severe
  - (c) European bank losses of $1.1 trillion
  - (d) China's expected growth due to fiscal stimulus

Policy challenges

- Threat of deflation now, and expectations of future inflation given debt/monetary easing
- Prolonged period of deflation would be damaging – raises real burden of debt
- US headline consumer prices falling, mostly due to energy prices, core inflation running at 1.8% (excludes food and energy)
- Even in 2010 when impact of cheaper fuel fades, inflation will be well below 2% stability range in many advanced economies

Policy challenges

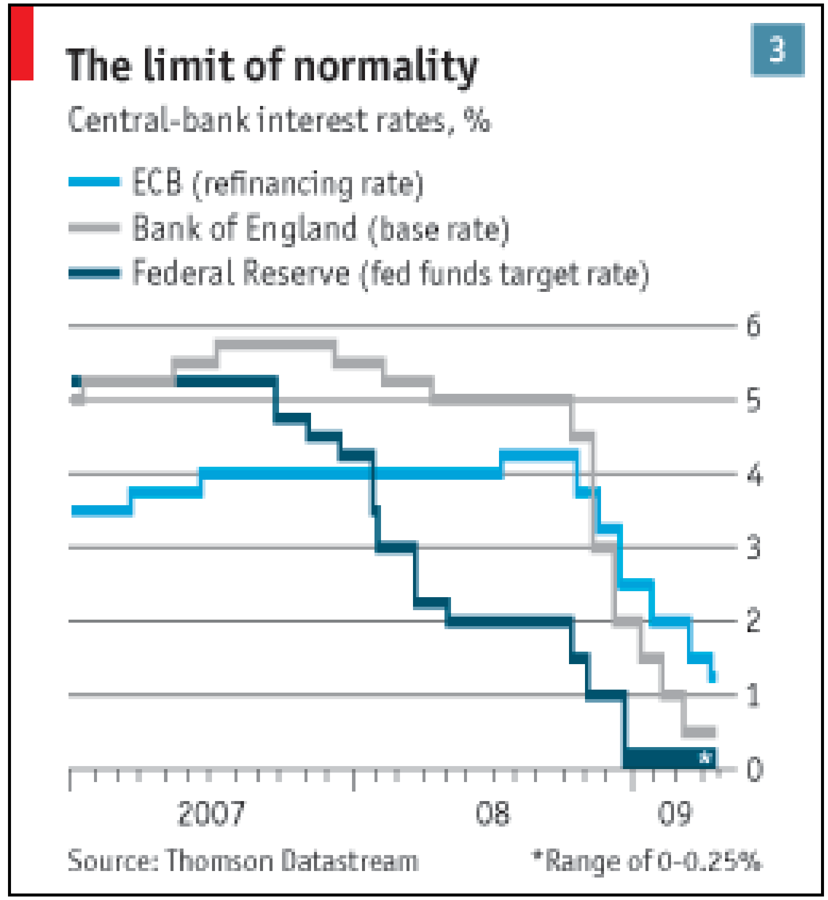




Monetary policy

- Focus of monetary authorities has shifted from inflation targeting - bursting of asset bubble has raised threat of deflation
- However, monetary authorities do not have much room for maneuver on interest rates - relying now on “quantitative easing”
- With short-term rates being close to zero, central banks expanding money supply through purchase of bonds as well as private debt

Monetary policy



Future of monetary policy

- Central banks will wind down current measures when crisis ends - Federal Reserve actually required to by law
- Abandoning inflation targets unlikely - would dent hard-won central bank credibility
- However, aim may be path for price level rather than inflation rate
- Also likely to adopt "macro-prudential" supervision, i.e., evaluation of systemic risk in banking system

No need for complacency

- Preventing possible deflation will require unconventional policies for some time – but requires clear exit strategy
- Fiscal stimulus should not be taken back, i.e., rush to raise taxes will hurt recovery
- Banks have to be restructured/cleaned up
- Surplus countries need to stimulate spending
- Governments do need to consider how to lower debt ratios without choking off demand