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briefing paper

Synchronized Dive into Recession: Focus on Damage Limitation

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Summary points

- The global financial system has suffered a once-in-a-century meltdown that almost brought the world economy to a halt in late September. Confidence and trust have been shattered. In spite of concerted and extraordinary efforts on the part of central banks and political leaders, including recapitalizing the banks, it is not yet certain that the waves of panic and destruction have been halted. Many of the repercussions have yet to emerge, including possible legal action as well as economic damage.
- Even before this latest explosion, the leading OECD economies were plunging into an unusually synchronized recession, driven by the simultaneous collapse in consumer and business spending. This will now get worse.
- Will a severe OECD recession engulf the rest of the world? Up to mid-2008, the emerging markets remained strong – 'decoupling' did work. Now the crisis has deepened, no region will remain immune to shock waves.
- This time round, the outcome for China will be much more important because it has doubled its share of world GDP over the last decade and is now the single largest contributor to global growth. China will fight to avoid recession, but can it win? If it can keep up growth, bolstered by its enormous pool of savings pent up in the banking system, this will provide important sustenance for the global economy.
- Without doubt, this crisis will require substantial, persistent and coordinated global efforts to turn around – possibly including yet more extraordinary 'out of the box' measures. The US and EU are now getting to grips with the immensity of the task. The message has become 'whatever it takes' to halt further widespread destruction.

Introduction

As the financial crisis entered its latest, explosive phase, the leading OECD economies were already diving into an unusually synchronized recession, driven by a simultaneous collapse in consumer and business spending and the rising threat of job losses and bankruptcies. This creates a vicious circle: deteriorating economies drag down prospects for companies and debt defaults, which further damage financial markets and thus the economies concerned. Panic is adding to the rapid downward spiral. If the world's central banks and political leaders do not restore order soon, the recession will become a slump.

For the financial economy, it is now a much greater problem than simply adding up the bad debts, even though this figure has become bigger and more widespread. On top of this are the pernicious effects of marking down all debt – good and bad – on the basis of the dramatic slide in asset prices. Such a mark-down has the potential to destroy more financial institutions: few have the cash and reserves to readily cover the gap, and raising new funds in current conditions is virtually impossible. Central banks and governments are helping out but there may be too little to go round. US Treasury Secretary Henry Paulson was warning during the summer of the need to bolster positions as quickly as possible – now we can see why he was anxious for people to heed these words.

For households and companies alike, the risk is no longer limited to cutting spending plans. The immediate threat is the freezing up of credit and struggle to access working capital that pays wages and input costs. The loss in spending already in the pipeline is enough to cause a nasty recession: GDP will probably fall by at least 1–2% in the US and Europe in 2009. However, taking account of the current turmoil, the drop in GDP could escalate to proportions more typically seen in Third World debt crises. Some suggest a drop as big as 10% during the next few months.

To illustrate the stark impact of the credit crunch, the State of California is having problems with credit lines necessary to pay teachers' wages. This is the type of problem that hit Russia in the mid-1990s but was never expected to be seen in the US. In the worst phase of the 1997–98 crisis, Asian companies could not even get finance to ship goods out of the factories and ports; it seems unbelievable that this threat is now being contemplated on a global scale, bringing the World Trade Organization into crisis talks. For the consumer, this is equivalent to finding that plastic is no longer accepted and cash machines close. If voters want to know why central banks and governments have to lead a bail-out for the global financial system, they should think of the consequences for themselves of such a collapse in trust and the monetary system.

> 'Steady Chinese growth offers the best hope for limiting the damage to the world economy through the present crisis'

Will this recession engulf the global economy? Up to mid-2008, the emerging-market economies remained strong (Figure 1a) and the process of 'decoupling'[1] that had been in evidence for some years offered the hope that they could keep world growth going. Now the crisis has deepened so dramatically that it will have impacts everywhere: the financially weak are already seeing escalating risks and the threat of meltdown, while even the strong are suffering the effects of the world's leading economies pulling back cash and credit in the effort to survive. The World Bank and International Monetary Fund are bracing themselves to help meet the forthcoming shock waves. However, at the global level, it is the outcome for China

1 We note that decoupling is used as a scientific term, generally implying a disconnection or break in a previous relationship. In economics it is used to refer to breaks in trends such as stock-market correlations and the energy/GDP ratio and not just to changes in global growth correlations, although this is the usage that has most often appeared in the news headlines over the last couple of years. In this briefing, we focus only on the question of GDP correlations across countries and regions. The problem of definition and evidence regarding decoupling is addressed in an accompanying paper published by Chatham House. This issue has also been illustrated in presentations and reports by M. Ayhan Kose, IMF; see, for example, Kose (2008).

that is of exceptional importance. It has been the mainstay of world growth over the last couple of years – indeed it has doubled its share of world GDP over the last decade and the Chinese economy is now the main contributor to global GDP growth. Steady Chinese growth offers the best hope for limiting the damage to the world economy through the present crisis.

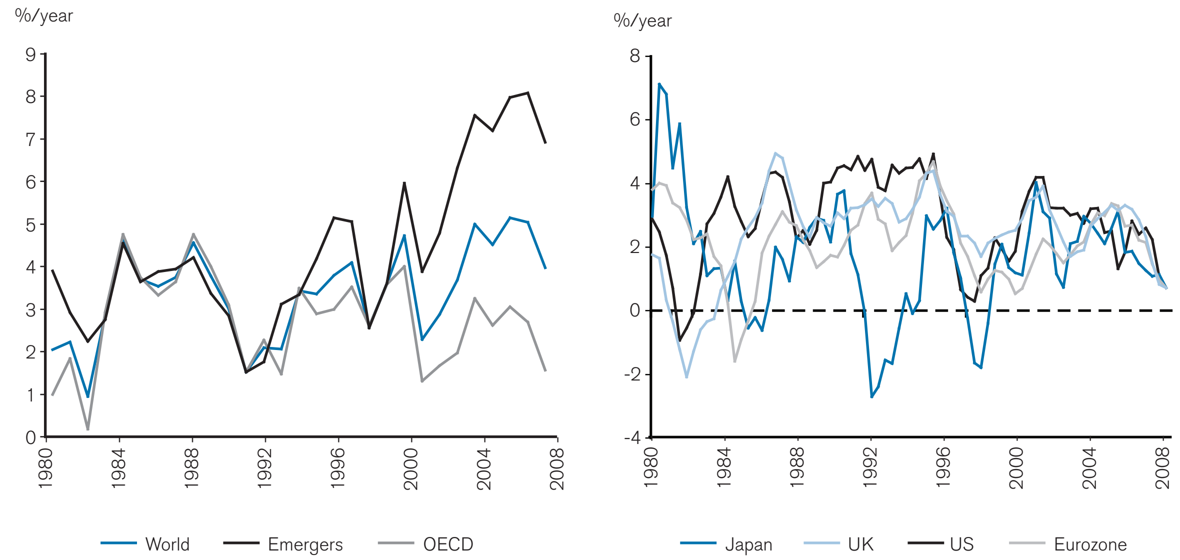
It is increasingly doubtful that any region will remain immune from the crisis even if some countries, hopefully including China, can avoid outright recession. The highly coincident weakening in the US, Europe and Japan points to a substantial shock to global trade and commodity markets; there are lingering impacts of previous steep increases in fuel and food prices, especially in developing countries; the boom-bust in property has hit many countries; and the panic in stock markets is global. This is a toxic cocktail for the global economy, and simultaneity deepens the impacts.

Risk of steep recession as financial system implodes

Right up until October, before the immensity of the latest phase of the financial crisis became obvious, it was possible to argue that the world economy could avoid a serious slowdown and the US would start to see a recovery emerge in 2009. Now the OECD is on the brink of economic disaster and the outlook for 2009 is bleak. Global growth will be dragged down by a slowdown in the emerging markets coupling with recessionary conditions in the major developed economies (see Figure 1b). How bad will this be and can anything be done to limit the damage?

Clearly this new stage of the financial crisis will lead to forecast downgrades. Consensus estimates right up to September continued to sit on the fence: a poor performance for the OECD bloc was expected to run alongside slightly weaker, but still fast, growth in the developing world. The optimists should have gained support from the sharp fall in commodity prices over the summer, which is already feeding through to lower consumer price inflation[2] (for example, China's inflation fell to below 5% in August and September from a peak of more than 8% in spring, and the US inflation rate has also edged down). But the rapid deterioration in the European economy, a substantial surge in US unemployment and yet more massive turmoil in the financial sector encouraged

Figure 1: GDP growth: emergers still riding high in 2008 while the OECD moves towards a synchronized slump



Source: IMF.

2 This will up-end the arguments put forward during the oil price surge that inflation was taking off and would cause a more widespread economic downturn (see, for example, Posen, 2008).

pessimism instead. Consumer confidence and spending in both the US and EU are seeing a massive simultaneous slide, as exemplified by the collapse in auto sales and the pain being felt on the high street. This bodes ill for business spending, especially in view of the increasing difficulty in accessing working capital.

In spite of recent adjustments, most forecasts remain behind the curve because of the speed and intensity of the financial storm. Impacts on emerging markets are still expected to be very modest, as illustrated by the small shift in IMF forecasts released at the start of October (see Figures 2 and 3). However, the latest data indicate that the OECD bloc is already falling into a steep recession in the second half of 2008 and this will deepen in coming months. Severe problems in housing and banking may take several years to resolve, as they typically have in the past. The leading countries will be lucky to see signs of a pickup before late 2009 and the recovery could be exceptionally fragile.

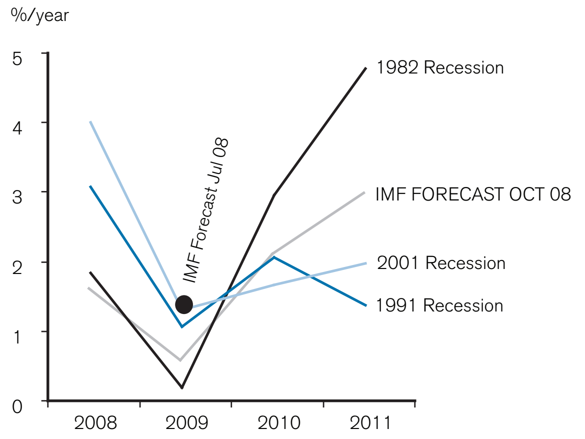
How will this downturn compare with previous recessions? The threat of a recession on a similar scale to that seen in 1982 (or worse) is uncomfortably high, even though inflation risks are much lower today. The latest IMF forecasts have moved in this direction, as Figures 2 and 3 show. But the IMF downward adjustment now looks too small and, unlike the big rebound that occurred at the end of the 1982 slump, the pickup may be both delayed and feeble.

If inflation falls as it typically has done during recessions, by next year there will be a serious risk of deflation. This would only exacerbate debt problems, as Japan found out, to its cost, in the 1990s.[3]

Mind the gap!

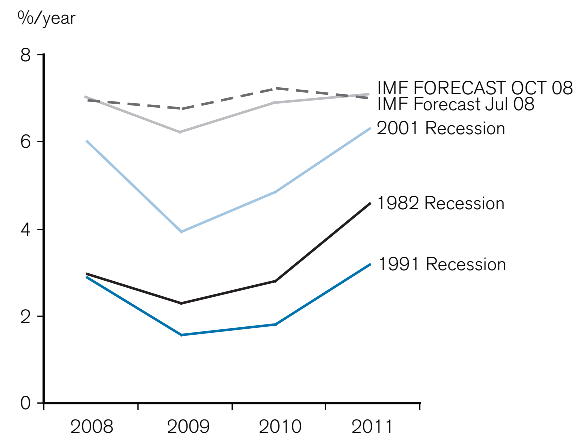
In principle the divergence (or decoupling) in old and new world growth trends that has developed since 2002 (in fact since 1992, excluding the Asian crisis period – see Figure 1) could continue, provided the emergers sustain *relatively* high growth rates. Until very recently, this was the favoured scenario: world growth would ease but remain reasonably robust. However, the gap in growth rates between the emergers and the OECD is even larger than that seen during Asia's early 1990s boom (up to the 1998 crisis). Since 2004, the gap has risen to as high as 4–5 percentage points (compared with around 2 percentage points in 1993–97). Those who expect decoupling to turn into an unpleasant 'recoupling' argue that the rise in the gap represents a build-up of risks. A potentially sharp correction may be due. The gap between the OECD and non-OECD growth rates could disappear abruptly because

Figure 2 IMF forecasts for OECD growth versus recession scenarios



Source: IMF, October 2008.

Figure 3 IMF forecasts for non-OECD growth versus recession scenarios



Source: IMF, October 2008.

3 See discussion of the comparisons between the Japanese experience and the current US and European debt problems in Turner (2008).

of a steep drop in the developing world's performance. The disruption seen across emerging financial markets in early October points to rapid recoupling becoming more probable – this is fast becoming the favoured scenario.

It certainly seems a lot to ask of the emerging markets that they could keep world growth going in the face of a very substantial OECD recession. However, a synchronized slump might only represent another 'one-off' worldwide jolt, similar to 1998. How robust are the emerging-market economies today? Can they achieve a speedy recovery and help pull world growth along on their own? What is the historical evidence for emerging markets taking over the driving seat of the world economy?

Global growth remarkably robust to mid-2008 thanks to the emergers

Recent trends in the emerging-market economies – and the global economy – certainly confounded the pessimists, especially those[4] who argued vehemently from the onset of the US slowdown in late 2005 that this weakening would deliver a rapid blow to Asian trade prospects and world growth. Their analysis was wrong, in large part due to their poor assessment of global linkages. Clearly in 2009 there is a risk of a more generalized slowdown, but whatever the outlook for 2009, predictions that the global economy would be engulfed in recession have so far been wide of the mark. Aggregate GDP[5] continued to expand at close to peak rates up to mid-2008, in the 3.5–4% range (see Figure 1), in spite of an established slowdown in the US, the onset of the banking crisis, tumbling stock markets, commodity price spikes and, in the second quarter of 2008, a decline in Eurozone GDP.

The developing world has enjoyed over five years of buoyant growth and even saw growth quicken slightly, to over 7%, in 2006–07, although the rate has edged down in 2008, to around 6.5% by mid-year. This outcome contradicts the naïve concept of an automatic and immediate synchronization of the global growth cycle with that of the US (and OECD), which would have predicted a fall in global growth, probably to well below 3%, in 2006–07 as US growth slowed to rates that were much lower than long-run potential (generally assessed to be in the 3–3.5% range).

It is important to recognize that the pessimists were wrong – although they may claim they were ultimately right – not to gloat but because this has implications for further analysis and/or continued errors. There are at least three points that should be noted in this respect:

- Even if a synchronized downturn does occur in 2009, this is two or three years later than predicted by US-centric pessimists.
- The analysis underpinning these faulty forecasts may continue to be misleading regarding underlying trends and future global developments – in part this was due to lack of appreciation of the development of the emerging markets.
- The unquestionably robust outcome for world growth up to 2008 is all the more remarkable because US import growth did indeed weaken sharply from 2005, dropping to zero in early 2008 – the pessimists were correct about this but not about its implications.

Sustained high growth in the emerging-market economies has been supported by the successful diversification seen in the engines of growth, with stronger dynamics in domestic consumption in the emergers (notably in China and also the energy producers) offsetting slower growth of exports to the weak OECD. In addition, exports are becoming more diversified in terms of destination, and thus less reliant on US demand. The share of emergers' exports to the US has dropped below 15% of the total from a peak of about 25% a decade ago.[6]

The Asian economies in particular appear to have rapidly diversified exports away from the previous US centre of gravity, trading more with each other and the fast-growing Middle East. Notably, China is now the

4 Such as Roubini (reported in various newspaper articles in 2005–06).

5 Real GDP growth measured at market exchange rates (MER), IMF and World Bank estimates.

6 Estimates quoted by Kose (2008) and also by Oxford Economics.

leading destination for many Asian exporters, while China itself has overtaken the US and the major European economies in terms of exports to the Gulf region. The emergers have consequently avoided the slowdown in trade that many expected to see as US import growth fell. Even the US has also seen strong export growth offset weakening domestic demand. This has rebalanced its own growth from the internal to the external sector and helped reduce its trade deficit. In this sense, there has been some convergence towards more favourable, balanced trends in the world economy.

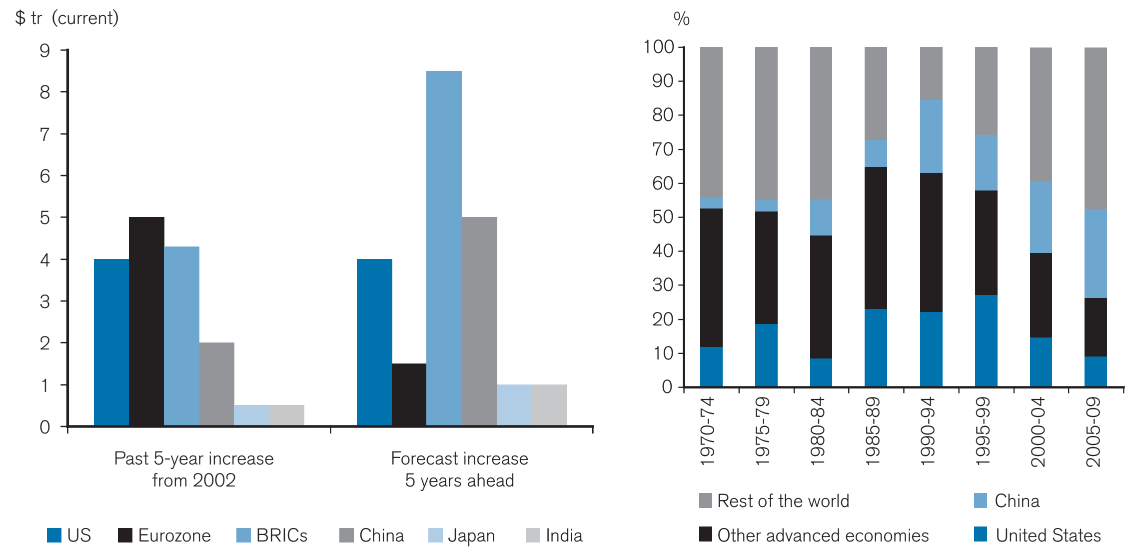
Such diversifications and their implications (decoupling is possible, the US consumer is not the most important driver of global demand) do *not* conflict with the concept of globalization. Indeed, the success of growing cross-emerger trade and diversification in the drivers of growth should be seen as confirming the *benefits* of globalization. These benefits become more apparent as the emergers get to stand on their own, collective, feet and even help sustain US growth by boosting world trade. Globalization need not mean that global growth depends on the US consumer if the sources of growth are diversified and better balanced.

Developing world's rising contribution to global GDP offers hope for future

Persistently high *global* growth has been due not just to the sustained buoyancy of emerging markets,[7] especially China and the energy producers, but also to the greater impact this now has on global GDP because of the rising weight of the emergers in the world total. The uptrend in the emergers' GDP share has accelerated markedly over the last decade. Recent figures clearly demonstrate the increasing ability of the bigger, stronger developing economies, led by mega emergers such as China, to drive the world economy, taking up the reins from the previously dominant US.

In terms of contributions to world GDP gains, China alone is overtaking the US, while India is neck and neck with Japan. The EU only temporarily boosted its recent standing (in current dollar terms) owing to the impact of the surge in the euro from 2006 to early 2008. In terms of their collective contribution to growth, the emergers are

Figure 4: Leading emerging markets' contribution to GDP growth



Sources: Own assessments and IMF estimates.
Note: BRICs = Brazil, Russia, India and China.

7 It is assumed that 'emerging markets' and 'developing world'/'developing countries' include the six Gulf Cooperation Council states (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates), in spite of these economies recording GDP/capita well above developing-country levels. This is in line with classifications such that adopted by the IMF.

now poised to exceed the OECD[8] (indeed they already have in PPP terms, as measured by the IMF – see Figure 4). Even allowing for a further (moderate) slowdown in the developing world and a likely recovery in the US and EU by 2010, the emerging-market bloc should remain the dominant contributor to the expansion of world GDP.

This historical experience and data suggest that if the outlook for emerging market and global growth is going to be seriously threatened, it will not be due simply to the impact of weakening US import demand on trade. The twin engines of Asia and the Middle East shrugged off the drop in growth for exports to the US starting in 2005. A non-OECD recession must involve additional risks such as a slump in domestic investment and consumer confidence. In this respect, there are now worrying signs that the Chinese property market is in trouble, while the slump in the stock market is also causing rising tensions. Similar problems are emerging in Russia and the Gulf states. The property boom-bust has been widespread and the impacts of the financial crisis are also being felt around the world, with dislocation effects even in cash-rich economies. This is the most dangerous risk to these economies in late 2008.

Although the immediate outlook for the world economy looks grim, the historical experience of the emerging markets pulling the world economy along will point the way forward when recovery gets under way. Another positive factor has been the growing cooperation across central banks in the face of a serious and common challenge; indeed the degree to which all countries have seen similar impacts and responses to the crisis has heightened the sense of 'all being in this together'. Perhaps this bodes well for further global policy coordination in other arenas.

Conclusions

The current crisis in the financial system has to be controlled as quickly as possible to avoid panic destroying yet more companies as well as many people's livelihoods. Collateral damage is rising rapidly. This is the reason why central banks and governments are putting their hands in the taxpayers' pockets, and rolling the monetary printing presses, to help stem the momentum of the slide and limit the destruction of otherwise healthy parts of the economy. If they can turn around the 'dash to cash', then more private savings can be mobilized in the task of limiting damage and bringing about recovery.

'The emerging-market economies have moved into the driving seat of the global economy'

In terms of the global overview, what has emerged strongly from the pattern of growth seen in the last few years and from the coordinated global efforts to regain control over the world's financial system is the understanding that we operate within a single global economy and financial system – *and that it is now too big for any one country to control on its own*. Central banks have moved fast to open up channels of cooperation and coordination of policies. And we can clearly recognize the important part played not just by the leading OECD economies but by the emerging markets too. Indeed, the emerging-market economies have moved into the driving seat of the global economy: they are now big enough, sufficiently interlinked and successful in promoting pro-growth policies to sustain their own growth in trade and GDP against a background of low growth in the US and other major OECD economies.

Whatever the outcome for 2009 turns out to be – most likely a severe global downturn – long-term trends will reveal a continuation of the previous pattern of growth, with the emerging markets, led by China, racing ahead once more, as they did following the crises of the late 1990s. They may even come to dominate the global business cycle.

But first, a massive global effort is needed to turn around the current crisis, including some extraordinary 'out of the box' measures. Indeed, the EU and US are already embarked on unprecedented action to recapitalize their banking sectors. Other questions continue to

8 Using GDP at MER, in PPP terms, the emergers' contribution to GDP growth is much higher, close to 70% according to IMF statistics (see, e.g., Kose, 2008).

be raised, for example over relaxing the heavy-handed 'mark-to-market' system (the requirement to value assets at spot market prices) that has added to cyclicality and risk. In desperate conditions, unusual remedies may have to be applied. Bans on short selling have already been implemented and many bourses are applying limits on volatility. Such measures may have to be extended while governments do their utmost to stem panic. Some countries have closed their financial markets and such action may be necessary at times simply to allow traders to work through the maelstrom and the implications of potential lawsuits that could arise out of this crisis. Buying breathing space – even a few days – may be critical in these circumstances.

The clear message last year to companies and individuals alike was 'get a plan – and make it as robust as possible'. Now the message to the authorities has to be 'whatever it takes' – which may have to be something truly remarkable.

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WTO Trade Statistics

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