Financial meltdown averted – but how deep and how widespread will the recession be?

1. What has happened so far?

The credit crunch that began in July 2007 intensified dramatically in September 2008, with a series of bank failures prompting rescues and effective nationalisation of major financial institutions in the US, the UK and the Eurozone. Despite massive intervention, financial stress rose to new highs at the start of Q4 2008 as financial markets dried up, with treasury bond yields falling, interbank lending rates still high, emerging market spreads widening sharply and stock markets plunging further. Faced with financial sector meltdown, many governments have recapitalised banking sectors and guaranteed interbank loans and bank deposits to try to shore up confidence in the financial system. These moves have averted a meltdown, but the spotlight has moved onto the rapidly weakening real economy – both world growth and world trade are now expected to decline in 2009, making it the worst year since 1945.

2. How big is the financial crisis?

So far, global banks, mortgage lenders and insurance firms have announced write-downs of over US$790 billion, amounting to around 2.7% of US and European GDP. As well as further sub-prime write-downs, default rates are rising on ordinary mortgages, commercial property loans, consumer loans and corporate loans and bonds. Using typical default rates for recession periods plus an estimate of final losses on mortgage-backed securities and other structured products, we estimate the final losses of the banking sector at around US$1.9 trillion, equivalent to about 6.5% of US and European GDP. This would still be below the scale of the Japanese or Asian banking crises in the 1990s, but of course far larger in terms of total cost and in terms of significance for the global economy.

3. How have policy-makers responded?

Faced with possible financial meltdown, there has been a massive increase in central bank lending to the banking system and rescue packages totalling almost US$3 trillion have been announced by governments around the world. In the US the US$700bn Paulson Plan started with US$250 billion recapitalisation of the nine largest banks. In Europe over €1 trillion has been made available in the Eurozone to guarantee interbank lending with another €200bn for recapitalisation of banks. The UK bailout involves nationalising or part-nationalising leading banks at a cost of £50bn, with additional funding of as much as £325bn available in the form of loans and guarantees. These moves have offset some of the funding gap that banks face as a result of the seizing up of interbank markets.

Monetary policy has been eased aggressively – led by the US where interest rates have been slashed to just 0.0-0.25%. Japan has cut its policy rate to 0.1%, UK rates are down to 2% and the ECB has cut to 2.5% – and further moves are likely as inflation falls rapidly. Elsewhere, rates are also now tumbling as the threat of recession starts to bite. But lower interest rates usually take some 12-18 months to have an impact, so attention is shifting to fiscal policy in an attempt to bolster consumer and business confidence and to stem the rapid decline in economic activity.

4. What happens now?

With interbank lending starting to resume, albeit very cautiously, market rates coming down and some evidence of greater stability among financial institutions, a financial meltdown has been averted. But the situation remains fragile and there are still risks. After years of rapid growth, hedge funds are suffering serious losses, which in turn may sharply depress activity in the credit default swap market and have ripple effects in the fragile banking sector. Moreover, emerging markets are proving more vulnerable than expected as trade finance dries up, capital inflows dwindle and rolling over short-term debt becomes more difficult. In addition, the stronger US$ has reversed corporate hedging strategies at the same time as investors are dumping emerging market assets. This has led to much higher emerging market spreads and, in an increasing number of cases, the need for emergency IMF funding.

Although the financial crisis appears to have been stemmed, the big question now is how long and how deep the recession will be. Even though further bank collapses may now be avoided, it is clear that banks will continue to deleverage and will remain reluctant to lend until they are confident that they can see an end to the fall in asset prices, and hence the end of risk of lending to other banks. This point has not yet been reached as stock markets remain volatile and house prices are still in decline in many countries, so the slide into recession will continue. With the major developed economies all expected to contract next year and aggregate growth in the emerging markets slowing, world GDP is seen shrinking 0.4% in 2009, the first drop since the Second World War. As a result, further monetary policy responses are likely, including quantitative easing by central banks in a number of countries, in particular in the US and the UK.

And fiscal stimulus, deeply unfashionable for much of the last 30 years, is also back in fashion. China has announced measures worth up to 14% of GDP, the new US administration is considering a 5.5% of GDP boost, Japan has announced a package worth around 4.5% of GDP and in Europe stimulus packages averaging around 1.5% of GDP have been announced in the major countries.

5. How the financial crisis is impacting on the real economy?

- **Weaker consumer spending.** Households are retrenching sharply to improve their financial positions. Driving this is the difficulty in accessing consumer credit, the need to rebuild savings and rapidly rising unemployment. The risks are especially high in the US and UK, where savings rates have been very low – our forecasts now show personal consumption falling 1.3% in the US and 2.3% in the UK in 2009. The Eurozone, where savings rates are higher, is better placed but even so private consumption is expected to fall 1.2% next year.

- **A much tougher environment for companies.** Companies have already been hit by much weaker demand from consumers as well as more expensive and scarcer credit. As asset prices have slid, banks' balance sheets have been hit and credit has become much more difficult to obtain and more expensive. Despite the deep cuts in official interest rates, higher corporate bond yields mean higher borrowing costs for firms, which have already responded by cutting operating costs, shedding labour and postponing investment – all happening much earlier than in previous recessions.

- **Government finances**. Budget deficits and public debt will rise significantly across the major economies in the next 2-3 years as governments spend heavily. The combination of a deep recession, fiscal stimulus and bailouts of the banking and other sectors like autos will see fiscal deficits balloon in 2009 and 2010 – possibly to doubledigit levels as a % of GDP in countries like the US and UK. This will help to soften the recession, but there may be long-term inflationary consequences from the stimulatory policies unless policy is tightened once the recovery begins.

- **Lower inflation and interest rates**. The sharp slowdown in global growth and lower commodity prices mean a rapid decline in inflation is under way. With oil prices down some 70% from their peak, inflation in the major economies will continue to fall steeply next year, reinforcing the prospect of further interest rate cuts in the UK, the Eurozone and in many emerging markets. In the short term, the threat of deflation is now a serious one.

- **Exchange rates**. The flight to safety has seen the US$ strengthen since July 2008. The stronger US$ has also added to downward pressure on commodity prices, in particular oil, helping to ease the squeeze on consumers' real incomes, but this will be offset in some countries by further currency depreciation, which in turn may reverse the process of currency appreciation considered necessary to unwind the large bilateral trade imbalances that have built up between the US and some Asian emergers.

- **Weaker world trade.** Slower world trade, which is now forecast to contract almost 1% in 2009, will affect all countries. Among the emerging countries already being hit hardest are those that have been heavily dependent on exports for growth, such as South Korea, Taiwan and Hungary, while many others are also being hit as access to trade finance is squeezed. The BRIC economies should be less affected given their stronger growth in domestic demand, but even China and India have relaxed policy quite aggressively in order to support their flagging economies.

- **Emerging market slowdown.** In addition to being hit by lower trade and falling commodity prices, emerging economies that rely heavily on external financing, such as Turkey and South Africa, will come under pressure. Many of the emergers have also been affected by currency depreciation against the US$, with Brazil, Argentina, Mexico, South Africa and South Korea having suffered substantial withdrawals of capital. Countries that are net creditors or with financial systems that are less integrated into the global system, such as China, the Gulf states and, to a lesser extent, Indonesia are less vulnerable. But oil producers (especially Russia) are being hit by the collapse in oil prices, with this year's hefty surpluses expected to dwindle sharply in 2009. Among the other emergers, Hungary, Ukraine and Pakistan have needed urgent access to IMF funding, and others with large current account deficits or debts that need rolling over may find their currencies under severe pressure and require additional funding.

6. What is the growth outlook?

Our baseline forecast sees declines in all the major economies in 2009. Despite the aggressive monetary and fiscal easing, the US, the Eurozone, and the UK are all now seen contracting by around 2% this year. But the earlier and more dramatic policy response in the US, including an anticipated fiscal stimulus of over US$500 billion early in 2009, is expected to result in the start of recovery later in the year, leading to GDP growth of 2.9% in 2010. The upturn in Europe will be much slower – in the UK and the Eurozone, we expect growth of just 0.8% in 2010

.

The BRIC economies will continue to grow, but there will be a clear downturn. China is now forecast to grow by about 5½% in 2009, its lowest since 1990, India is seen slowing to about 4% and Russia, which is much more at risk from the financial market crisis, is likely to contract this year after growing by around 6% in 2008. Latin America is expected to grow by under 1% in 2009 – with Brazil suffering despite the fact that its external sector is relatively small as a share of GDP and Mexico being hit hard because of its close trade and investment links to the US – before recovering to around 3% in 2010. Growth in Asia is likely to stall in 2009 before recovering to around 4% in 2010, a little better than last year's expected outturn. Of the main emergers, some are highly exposed to financial market turbulence and exchange rate risk, in particular Turkey, South Africa and Russia (despite its high energy exports). The least vulnerable of this group are considered to be China, India and Brazil, although Indonesia should also be relatively sheltered.

Recent events have greatly increased the level of uncertainty around the central growth forecast, and there is a risk of a more severe downturn, with the policy response seen to date failing to stabilise the situation and the US economy remaining in recession for longer than anticipated. In this scenario, world GDP would remain very weak in 2010, posting growth of just 0-1% after the decline of 0.4% in 2009. All of the major developed economies would post growth of little better than zero in 2010, which in turn would have a bigger adverse impact on the emerging markets, with even China and India suffering further slowdown as world trade failed to recover. This would certainly add to the threat of deflation, quite possibly prompting an even more aggressive monetary and fiscal policy response. This in turn would add significantly to the chances of a period of higher inflation from 2011-12, but inflation is the traditional escape route from excessive debt and would guard against a repeat of the 1930's depression.

Credit crunch timeline

Apr-07	**New Century Financial, subprime lender, files for bankruptcy**
Jul-07	Credit crunch begins, sharp rise in financial market volatility **Bear Stearns hedge funds collapse** Bernanke warns subprime losses may reach US$100bn
Aug-07	BNP Paribas halts withdrawals from hedge funds due to liquidity problems *Fed cuts discount rate 50bp to 5.75%* **Sachsen Landesbank sold to LBBW due to subprime losses**
Sep-07	Sharp rise in interbank rates Northern Rock seeks emergency support from bank of England *Fed cuts funds rate 50bp to 4.75%*
Oct-07	UBS announces first subprime losses of US$3.4bn Citigroup announces US$9bn of losses, Merril Lynch US$7.9bn *Fed cuts funds rate 25bp to 4.5%*
Dec-07	*Bank of England cuts rates 25bp to 5.5%* *Coordinated central bank liquidity support to cover year-end needs - succeeds in temporarily lowering interbank rates* S&P downgrades several monoline insurers *Fed cuts funds rate 25bp to 4.25%*
Jan-08	Major stock market falls in major economies *Fed cuts funds rate 125bp to 3.0% in two steps* MBIA insurance group announces US$2.3bn losses due to subprime
Feb-08	*Bank of England cuts rate 25bp to 5.25%* G7 estimates subprime losses could reach US$400bn **Northern Rock nationalisation announced**
Mar-08	*Fed offers US$200bn of liquidity support, biggest amount yet, extends to primary dealers* **Bear Stearns collapses and is acquired by JPMorgan** *Fed cuts funds rate a further 75bp to 2.25%*
Apr-08	IMF warns credit crunch losses could reach US$1 trillion *Bank of England cuts rates 25bp to 5%* *Bank of England announces Special Liquidity Scheme offering to swap £50bn of banks' illquid assets for Treasury bills* *Fed cuts Funds rate 25bp to 2%*
May-08	UBS launches US$15.5bn rights issue as losses reach US$37bn
Jun-08	More capital raising efforts - Barclays raises £4.5bn
Jul-08	**US mortgage lender IndyMac collapses** **Authorities announce support for US mortgage lenders Freddie Mac and Fannie Mae** HBOS rights issue in UK flops, leaving shares with underwriters *ECB increases rates 25bp to 4.25%*
Sep-08	**Freddie Mac and Fannie Mae rescued by US government** **Lehman Brothers files for bankruptcy, break up begins** **Merrill Lynch taken over by Bank of America** **Federal Reserve announces US$85bn rescue of AIG, government to take 80% of equity** **UK's HBOS taken over by Lloyds TSB** **Washington Mutual closed down, assets sold to Citigroup** **Belgium's Fortis rescued by Belgian/Dutch/Luxembourg government, Eur 11.2bn cost** Paulson Plan announced to buy bad bank assets worth up to US$700bn **UK mortgage lender Bradford & Bingley nationalised** **Belgian bank Dexia bailed out with Eur6.4bn** Further steep rise in interbank rates, sharp drop in equity markets US House of Representatives rejects Paulson Plan
Oct-08	*Bank deposit guarantees by Ireland, Greece, Germany, Denmark, Spain and Austria* US Senate and House of Representatives pass revised Paulson Plan **Second rescue of Germany's Hypo Real Estate** **Iceland currency collapse and nationalisation of banks** UK announces bank bailout scheme *Coordinated 50bp rate cut by in US, UK, Eurozone, Sweden, Canada and Switzerland* *Rate cuts in China, Korea and Taiwan* *Fed announces direct purchases of commercial paper* US plans US$250bn purchase of stakes in banks Bank bailout plans announced in Holland, Sweden, Korea, Switzerland, Austrai, Belgium, France, Germany, Italy and Greece. Asset purchase plans in Spain and Belgium. *Fed cuts rates further 50bp to 1%* **Merill Lynch, Citigroup and UBS announces further US$18bn writedowns in Q3** *Japan cuts rates to 0.3% from 0.5%, India cuts rates 1%*
Nov-08	IMF bailout packages for Ukraine, Hungary, talks with Pakistan & Iceland China fiscal stimulus package of US$586bn *Bank of England cuts rates 150bp to 3%.* *ECB cuts rates 50bp to 3.25%* Fiscal stimulus packages announced in Germany, Spain and France Eurozone proposes coordinated €200 billion stimulus effort **Rescue package for Citigroup - US$20 billion of equity and US$306 billion of guarantees** *Federal Reserve to purchase up to US$800 billion of asset- and mortgage-backed securities* *Fed Chairman Bernanke discusses possible purchases of Treasury bonds*
Dec-08	*Bank of England cuts rates 100bp to 2%, ECB cuts 75bp to 2.5%* *Federal Reserve cuts rate to 0-0.25%, Bank of Japan cuts to 0.1%*
Jan-09	*Bank of England cuts rates to 1.5%*

Latest forecasts

World GDP Growth % Change on Previous Year						
	2005	2006	2007	2008	2009	2010
US	2.9	2.8	2.0	1.2	-2.0	2.9
Japan	1.9	2.0	2.4	-0.5	-3.0	0.8
Eurozone	1.8	3.0	2.6	0.8	-2.1	0.8
of which:						
Germany	0.9	3.2	2.6	1.1	-2.3	1.0
France	1.9	2.4	2.1	0.7	-1.9	0.5
Italy	0.7	1.9	1.4	-0.6	-2.2	0.4
UK	2.1	2.8	3.0	0.8	-2.1	0.8
South Korea	4.2	5.1	5.0	3.2	-2.4	3.1
China	10.4	11.6	11.9	8.8	5.6	9.7
India	9.1	9.8	9.3	7.5	4.0	7.1
Other Asia	4.8	5.3	6.0	1.5	-2.7	2.9
Mexico	3.1	4.9	3.2	1.9	-0.6	1.9
Other Latin America	5.2	5.6	6.3	5.1	0.6	2.9
Eastern Europe	5.8	7.3	7.3	5.9	0.9	2.4
World	3.5	3.9	3.8	2.1	-0.9	2.8
World (PPP)	4.4	4.9	4.8	3.3	0.1	3.4

Annex material

Financial institutions write offs, total to date and estimated final, US$bn (as of December 15)

	USA	Europe	ROW	Total
Write offs so far	473	278	42	793
Estimated further write offs	602	402	66	1070
Total write offs	1075	680	108	1863
Assets	56250	49500	61250	167000

Source: Bloomberg, Reuters, Oxford Economics

Financial institutions write offs, by region and sector, US$bn (as of December 15)

	Investment banks	Commercial banks	Insurance & GSE	Other
USA				
Write offs so far	96	321	56	-
Estimated total	136	529	207	203
Assets	4200	13300	8100	30650
Europe				
Write offs so far	-	250	28	-
Estimated total	-	409	72	199
Assets	-	24900	7100	7100
ROW				
Write offs so far	-	42	-	-
Estimated total	-	78	5	25
Assets	-	20200	-	41050

Source: Bloomberg, Reuters, Oxford Economics

Financial institutions ultimate write offs, by product and sector, US$bn

	Total losses	Banks	Insurance	Pensions/ Savings	GSEs/ Government	Hedge funds and other
Residential loans	292	220	9	9	45	9
Commercial real estate	101	67	9	8	8	9
Consumer loans	98	58	12	14	0	14
Corporate loans	213	128	10	11	0	65
Leveraged loans	21	15	2	2	0	2
Residential MBS	669	413	70	66	45	75
Commercial MBS	294	150	30	50	30	35
Corporate debt	84	46	8	20	0	10
CLOs	90	55	8	8	0	20
Total	**1863**	**1152**	**159**	**188**	**128**	**239**

Source: IMF, Oxford Economics

Cost of financial crises, historical comparison

	Gross cost US$bn	Cost as % of GDP
US savings and loans 1980s-1990s	230	2.0
Sweden 1991	11	3.6
Finland 1991	12	12.8
Japan 1997	750	24.0
Asia 1998-1999	400	35.0
Current crisis - so far	793	2.7
Current crisis ultimate	1863	6.4

Source: IMF, Oxford Economics. All figures in column 1 in 2007 US dollars.

Notes: Asia consists of Indonesia, Korea, Philippines and Thailand. Current crisis losses expressed as % of US & European GDP