Leaders and laggards, on the way down and up

Executive Summary

- With the economies of most countries having passed their troughs, it is a good time to take stock of some of the main features of the crisis so far and to assess what the upturn may look like. In this article, we look back at how the different countries have fared in this crisis and how monetary and fiscal authorities have responded to the crisis. We then turn to the nascent recovery to compare and contrast the upturn across countries. Finally, we highlight some of the main legacies of this crisis.

- Exposure to financial services, housing booms, consumer debt and trade with the US were seen as factors that would make some countries suffer deeper downturns than others. In the event, the downturn has surprised by how quickly it has spread across countries. So the most affected countries turned out to be the most exposed to the world economy such as Germany, Italy, Japan and Eastern Europe.

- All major central banks have responded with aggressive cuts in interest rates and adopted wide-ranging unconventional measures. This has helped stabilise financial markets, but the goal of getting credit flowing to the non-financial economy has not yet been achieved. Governments have also responded to the crisis with large fiscal stimulus packages. These packages have helped contain the collapse in activity and contributed to some countries exiting the recession in 2009Q2. Whether these packages will be enough to get the world economy back on a sustainable growth path is still uncertain though.

- Beyond the short term, where fiscal stimulus and the stock cycle will boost growth, the recovery is expected to be sluggish and bumpy in most places. History suggests that recoveries from financial crises tend to be slower than others, and the repair of household and corporate balance sheets will be a drawn out process. In addition, with large amounts of spare capacity around the world, demand for investment will be weak for some time to come. Furthermore, the nascent upturn has already put pressure on oil and commodity prices. If this continues, it will hamper growth in net importer economies.

- These factors will combine with country-specific features that determine their potential growth. We forecast the recovery to be most drawn out in Italy, Japan and Germany as these countries are hit by weak demand for investment goods and are characterised by relatively low potential growth.

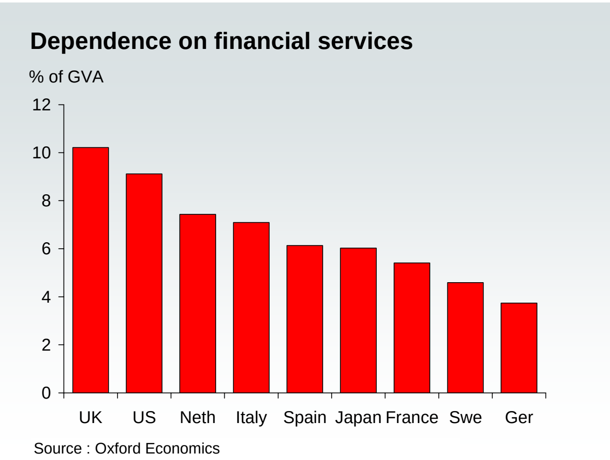
- One main legacy of this crisis is the likelihood of years of fiscal austerity, to bring public deficits back under control. Another legacy may be in changes to the regulation of financial services, although do date little progress has been made in this area. In addition, EMU has so far proved a resilient entity during the crisis, so that the euro could gain a more prominent role on the world stage, depending on how it fares in the upturn.

Introduction

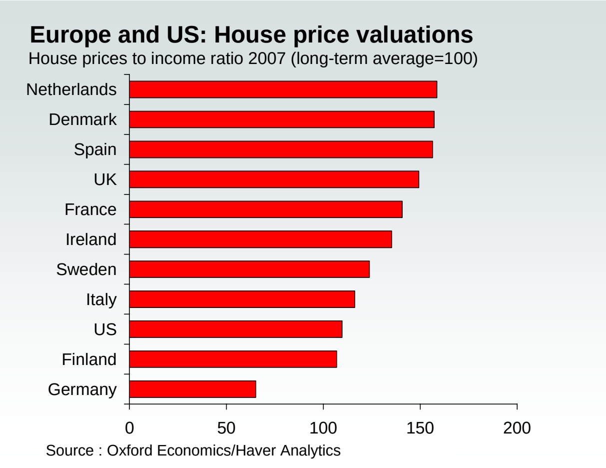
With the economies of most economies having passed their troughs, it is a good time to take stock of some of the main features of the crisis so far and assess what the upturn may look like. In this article, we look back at how the major industrialised economies have fared during this crisis and how monetary and fiscal authorities have responded. We then turn to the nascent recovery to compare and contrast the upturn across countries. Finally, we highlight some of the main legacies of the crisis.

Who should have suffered most…

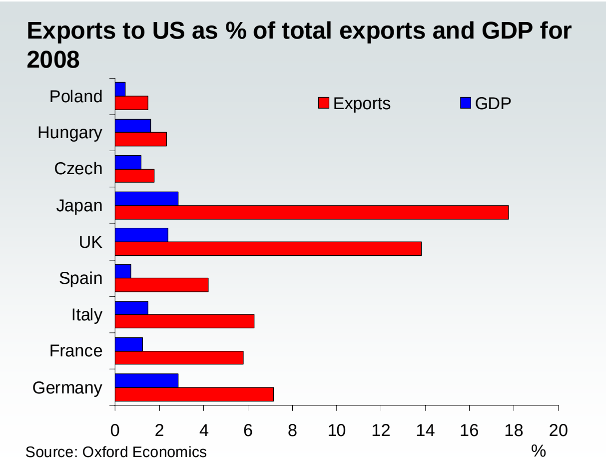
Before looking at how countries have fared compared with one another, let us put ourselves back at the beginning of the crisis and recall which countries were *expected* to suffer most. The crisis erupted in the financial sector in August 2007, in the wake of escalating distress in the US subprime mortgage market. Given the origins of the crisis, it was widely assumed that countries most dependent on financial services were set to suffer most. The UK and the US, with around 10% of value added accounted for by financial services were expected to fare worse than, say, Germany where financial services only accounted for 5% of total value added.



The crisis quickly spread from financial markets related to housing to real activity in housing markets. While many countries had experienced rapid growth in house prices in recent years, the extent of the increase and possible overvaluation differed widely between countries. In 2007, house prices to income ratios in the UK, the Netherlands, Denmark and Spain were around 50% above their long-term average. On this measure, overvaluation was not so clear in the US, while, in Germany, house prices had actually been falling relative to income.



A third – related – factor identified at the beginning of the crisis as one that should make some economies suffer more than others, was consumer debt. According to this criterion, the most exposed countries included Ireland, the UK, Spain and the US, while France and Italy were amongst the least exposed in the developed world.



Finally, with the crisis first becoming apparent in the US, exposure to the American economy as a market for exports was seen as a source of weakness in the unfolding downturn. Here, Japan, the UK and Germany seemed the most exposed.

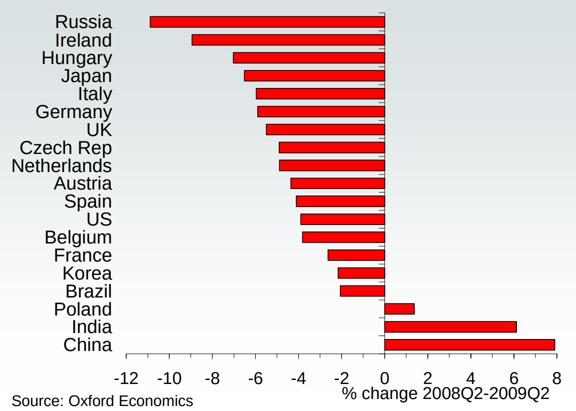
Put together, this analysis identified the US, the UK, Spain and Ireland as likely to suffer the most severe downturns, with Germany, France and Japan probably less affected.

…and who was actually hit hardest

In the event, some of the countries that could be thought to be relatively sheltered from the crisis have actually been hit harder than the US, the UK or Spain. For instance, in the year to 2009Q2, GDP in Germany and Japan was down 6.5% and 5.9% respectively, compared with falls of 3.9% and 5.5% in the US and the UK.

In fact, the downturn has surprised by how quickly it has spread across countries. Business confidence collapsed worldwide, banks tightened credit across the major economies, and investors took fright and withdrew funds indiscriminately from overseas investments. The most affected countries turned out to be those most exposed to the world economy, be it via trade especially trade in capital goods, capital flows or oil and commodity prices. Against this background Germany, Italy, Japan and the eastern European countries have experienced larger GDP falls than the UK and the US.

% change in GDP



Source: Oxford Economics

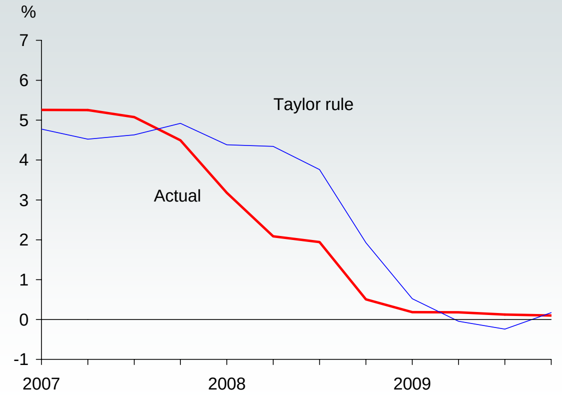
Swift action by central banks...

In the face of the rapid deterioration in economic conditions, all major central banks have responded with aggressive cuts in interest rates. The US Federal Reserve was perhaps the most active, cutting rates by more than 500 basis points in total with the first cut as early as September 2007. Indeed, the Fed cuts went beyond what would have been suggested by a so-called Taylor rules that bases a central bank's rate policy on the gap between inflation and the central bank's target and the output gap.

European central banks responded more slowly to the crisis. With Eurozone inflation at around 3.5%, the ECB was still in tightening mode until the middle of last year. It raised rates in July 2008 and then reversed course and started cutting them in October. Since then it has cut its refinancing rate by more than 300 basis points, down to 1%.

The Bank of England (BoE) embarked on its cutting cycle in December 2007, but relatively slowly at first. Things changed in autumn 2008, with cuts totalling 250 bp in November and December, followed by a further 150bp of cuts by March 2009.

Fed's policy rate



Source: Oxford Economics

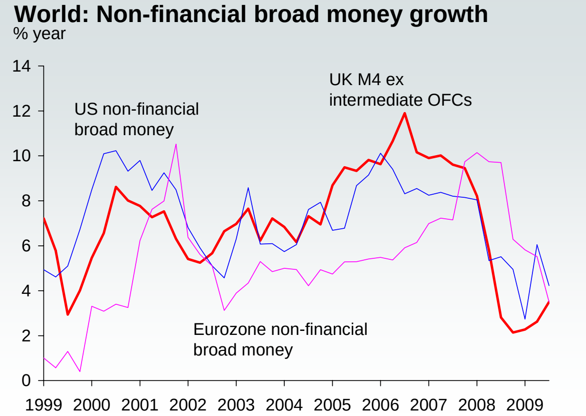
At present, the Taylor rule would suggest rates 'should' be at - or in fact below – zero, for both the Eurozone and the UK. In practice, the ECB and BoE have kept rates above zero but have also implemented ambitious non-conventional measures that make monetary policy looser than shown by policy rates alone.

The central banks have followed different strategies as regards use of non-conventional measures. In this respect, the Bank of England has been most active with a quantitative easing plan amounting to 13% of GDP and a trebling in the size of its balance sheet. The ECB balance sheet has risen by a more modest 50%.

It is too early to draw a firm conclusion about the effectiveness of these measures. It is clear that the central banks' swift action has helped stabilise financial markets. Spreads on interbank markets have returned to pre-crisis levels, and other measures of stress in financial markets have dropped markedly in recent months.

But the goal of getting credit flowing to the non-financial economy has not been achieved yet. The annual rate of growth of credit has dropped to around zero in the US, UK and Eurozone. Nonfinancial sector broad money growth meanwhile is running at an annualised rate of around 3.5-4%, below historical averages and implying a low rate of nominal demand growth going forward.

World: Non-financial broad money growth

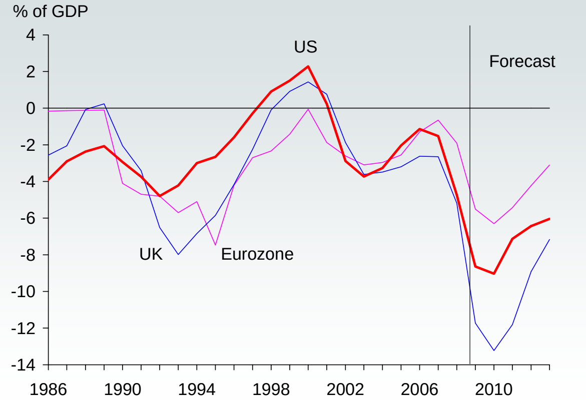


Source : Oxford Economics/Haver Analytics

…and governments

Governments have also responded to the crisis quickly, putting together large fiscal stimulus packages. The US fiscal package was worth around 5% of GDP, while in Europe, the announced fiscal packages have typically amounted to around 1.5-2% GDP. Part of the gap here is offset by the fact that automatic stabilisers are larger in Europe than in the US. So while the US government's fiscal deficit is forecast to widen by 8% of GDP between 2007 and 2010, the UK deficit is forecast to deteriorate by over 10% of GDP. The shift in the fiscal balance is expected to be somewhat narrower in the Eurozone, at around 6% of GDP.

World: Public sector deficits



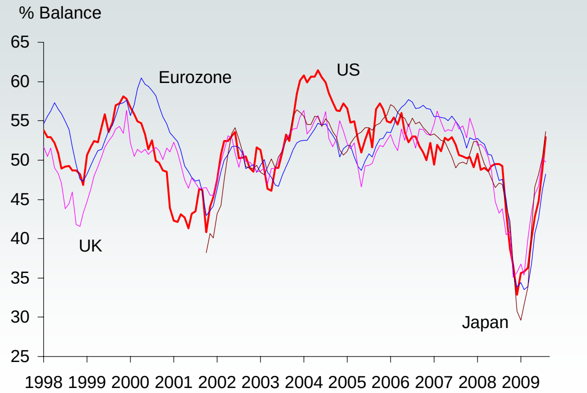
Source: Oxford Economics

The rescue packages have helped contain the collapse in activity and contributed to some countries like Germany and France exiting the recession in 2009Q2. The absence of any significant fiscal stimulus (due to very high initial levels of public debt) also partly explains why Italy has lagged its large neighbours. Whether these packages will be enough to get the world economy back on a sustainable growth path is still uncertain, though. At the moment, the recovery seems fragile and there is a risk of a relapse once the fiscal boost fades.

Synchronised upturns…

The national accounts for the second quarter and data on activity in the third quarter have confirmed that most economies have passed their troughs. Amongst the largest economies, Germany, France and Japan came out of the recession first, with positive GDP growth rates in 2009Q2.

Purchasing managers' indices

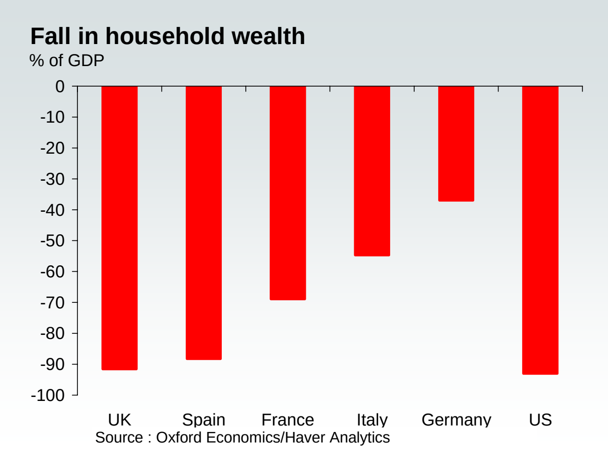


Source: Haver Analytics

In the second half of this year, GDP growth should be positive in most countries. Business confidence has rebounded significantly across the world, industrial production has started to rise again in several countries and world trade is picking up. Companies had responded to the collapse in orders by cutting inventories very sharply, but business surveys suggest that the pace of destocking has slowed sharply, which will contribute to demand in the second half of this year. Moreover, expansionary fiscal and monetary policy will continue to support growth in the remainder of this year.

… slow everywhere…

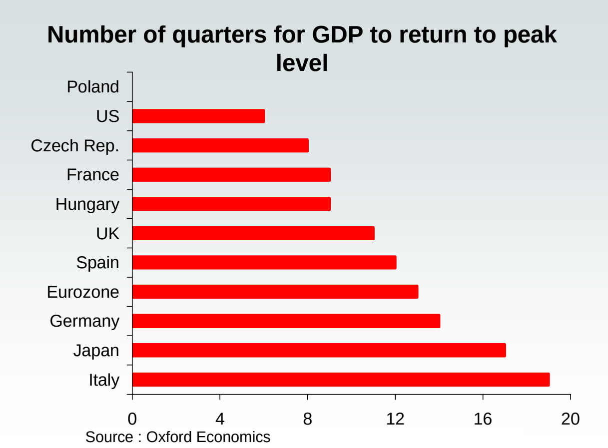
Beyond this initial phase, the upturn is expected to be sluggish and bumpy in most places. There are a number of factors behind this. Experience of previous recoveries from financial crises suggests they have tended to be more protracted than recoveries from non-financial recessions, as a hobbled banking sector holds the economy back. The repair of household and corporate balance sheets is also likely to be a drawn-out process. We estimate that the loss in households' wealth related to the fall in house and share prices amounted to around 90% of GDP in the US and the UK and only slightly less in Spain by end-2009Q1. Even given the bounce in asset prices since, rebuilding wealth levels will take years of savings which will dampen consumption.



In addition, the world economy has currently large amounts of unused production capacity as utilisation rates have fallen to record lows in many countries. This implies that investment to replace or extend capacity will be minimal for some time to come. Finally, although still nascent, the recovery in the world economy has already triggered a rise in oil and commodity prices. This will hamper growth in oil and commodity net importers.

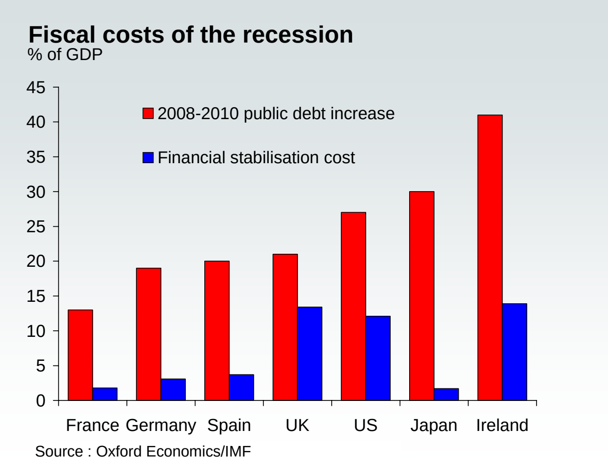
… but slower in some places

These factors will combine with country-specific structural strengths and weaknesses to influence the pace of recovery. Overall, we expect GDP in Italy, Japan and Germany to take longest to return to previous peak levels - between 14 and 19 quarters. Growth in these countries will be hampered by the slow uptake in investment worldwide. It will also be hindered by very slow potential growth.



Legacies from the crisis

A recession on the scale of that recently experienced will leave scars on the world economy for years to come. One of the main legacies will be the very large fiscal deficits accumulated by most economies. They will constrain government spending and tax policy for several years.



Another potential legacy relates to the regulation of financial services. Very little has been agreed upon so far, with much attention focusing on headline-grabbing proposals on bank bonus systems. To be effective, regulatory changes will need to be accepted widely across countries, but reaching an agreement will difficult because of divergent views and the lack of any obvious solution that would not impede economic growth.

A further legacy could involve the future role of the euro. EMU has undergone a severe stress-test during the crisis, but as yet has proved resilient. It is arguable that had they remained outside EMU, the economies of countries like Spain and Ireland might have suffered the kind of financial and currency collapse seen in Iceland. As a result, there have been signs of increased interest in joining EMU in a number of countries in eastern Europe, and in Iceland. Whether the Eurozone economy and the euro gain a more prominent role on the world stage nevertheless depends on how things fare in the upturn. If growth develops as we currently forecast, with the US outpacing most European countries, EMU will be seen as a resilient institution but not necessarily as a panacea that many countries will want to join or regions will want to imitate.