Nasser Saidi: Economics & Governance

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Whither the Great Recession? Reading the tea leaves

Posted: 30-Aug-2009

With the end of summer drawing close, questions concerning the trajectory of the world economy in the second half of 2009 will intensify. The second quarter saw a global improvement in economic conditions, but with striking diversity. Emerging Asia recorded sustained GDP growth led by China, while North America continued its slump, driven by profound adjustments in the U.S. (especially the labor market) and a weak auto sector (GM and Chrysler) despite the 'cash for clunkers' intervention. Europe was in the middle, with credit leveraged countries that resemble the U.S. (U.K., Ireland, Spain, Ukraine, the Baltics) and countries following in the wake of Asia thanks to recovery in industrial production (Germany, France, Poland, Scandinavia). The third quarter will evidence a crucial test for the global economy, i.e. whether the stabilization in Q2 will be followed by a recovery or whether there will be a 'double dip' recession. The forward looking equity markets are heavily betting on a synchronized global recovery; while the bond markets are comparatively bearish foreseeing a continuation of easy monetary policy –in the form of direct monetary injections or 'quantitative easing'- and weak growth, more of a U- or W shaped outcome. Both markets cannot be right.

Such a dichotomy is likely to persist and generate volatility in financial and commodity markets: the economic tea leaves portray a mixed picture so bulls and bears can find comfort in their convictions by attaching more importance to some data and neglecting other news. As economists, however, we should take higher ground and look beyond the short term. While 'timing' the end of the Great Recession is an interesting exercise, understanding the economic and financial factors shaping adjustment and sustained growth is more important from a GCC perspective. As commodity exporters increasingly integrated into the world economy, our focus should be on structural change and longer term forces at work.

The roots of the Great Recession and financial crisis can be traced back to the dotcom bubble. When the bubble exploded, US policy makers shunned the idea of engineering an orderly readjustment of the economy with the inevitable fall in standards of living to more sustainable levels (i.e. levels compatible with long term growth patterns and productivity growth, not those artificially boosted by the stock market exuberance of the roaring nineties). Instead the authorities went in the opposite direction substituting the collapsing stimulus from private investment with a hike in private consumption supported by lower taxes, lower interest rates and higher indebtedness of households. Household leverage, measured by the ratio of debt to personal disposable income, increased modestly from 55% in 1960 to 65% by the mid-1980s. Then, over the next two decades, leverage proceeded to more than double, reaching an all-time high of 133% in 2007, with the sharpest acceleration occurring since 2000. That dramatic rise in debt was accompanied by a steady decline in the personal saving rate, a process that enabled personal consumption expenditures to grow faster than disposable income, providing a significant boost to U.S. economic growth over the period.

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Similarly, loose US fiscal policy with increased military & security spending reversed a budget surplus in 2000 into sustained deficits that are expected to peak at some 11.2% of GDP this year. In this policy stance the US government was fully supported by the Federal Reserve which maintained interest rates abnormally low, fuelling debt and leverage across the financial system and disregarding asset price inflation. In essence in the early years of this century while the corporate sector was rebuilding its balance sheet to purge the debt overhang of the nineties, the household sector was led to increase its consumption and its already unsustainable liabilities, (sustained by home equity loans and mortgage refinancing). Before the US economy can be put back on a sound footing and sustained growth, the imbalances accrued over the last ten years need to be tackled and credibly resolved. The dilemma for economic policy is trying to address two conflicting objectives: reviving economic growth through a stimulus for increased spending and household (and financial sector) deleveraging which requires increased personal saving and lower consumption rates!

The process of adjustment and restructuring has barely started. At present a meltdown of the world economy has been avoided thanks to a massive injection of public money. In other words private debt in the US (and the UK) has been swapped by public liabilities together with a de facto nationalization of the banking sector. The process of recapitalizing and restructuring the banking system is just starting: the stock markets appear to have forgotten that the toxic assets are still in the balance sheet of the banks and that credit to companies continues to be scarce and is rationed!

But to restore sustainable growth, the current account deficit of the US and other profligate countries must be drastically reduced while the economies of heavy exporters such as China and Germany must shift to a greater focus on domestic sources of growth. This process will not be a matter of one quarter or even a few quarters as many market participants seem to believe. The Great Recession is still unfolding, with continuing heavy job losses in the US and more to come in Europe, where social protection is stronger, this adjustment will face several hurdles and set backs. Moreover once the world economy stabilizes, the US, UK and other EU countries will face to face the burden of dealing with the unprecedented peacetime build-up of the stock of public debt and reforming the financial architecture. For the GCC countries the outlook and developments in emerging Asia will be more important than those for the advanced economies of the west.