Recession and Financial Crisis: How Prepared Are We?

Willem H. Buiter*

Chief Economist and Special Counsellor to the President
European Bank for Reconstruction and Development

3 April 2001

Recession

The world economy is slowing down. Growth has declined most notably in the US, after almost a decade of strong and uninterrupted expansion. In Europe too, some weakness can be discerned, especially in Germany. The Japanese economy is performing much as it has been for the past decade – poised delicately between stagnation and decline. The industrial countries (excluding the newly industrialised Asian economies) account for just over half (54 percent in 1999) of world production and an even larger share (68 percent in 1999) of world trade (but only 14 percent of world population). A recession there would drag down output growth in the emerging market economies and the developing countries. International transmission of economic shocks occurs also through financial linkages and through confidence spill-overs. The Asian Development Bank recently produced a forecast for growth in Asia for 2001 of 5 per cent, against 7 percent in 2000.

The slowdown in the US is the response to the earlier unsustainable boom. Towards the end of the nineties, private demand was permitted to get out of hand. Consumption and investment were fuelled by a speculative bubble in the stock market, rationalised with projections of corporate earnings growth which implied that eventually all of GDP would be absorbed by profits. Projected long term productivity growth was revised upwards by 1.0, 1.5 or even 2.0 percent per annum – based on of five years or less of dodgy data. Pundits wrote the obituaries of the business cycle and of inflation, dead at the hands of the New Economy.

Drowned out by techno-babble, two key facts were forgotten. Market economies are inherently cyclical. Inflation is under control as the result of deliberate policy choices that have transformed institutions and rules governing monetary and fiscal policy and made them consistent with sustained low inflation. Anything that can be done through politics can be undone. If the political and popular consensus in support of low inflation were to vanish, inflation would return.

Unlike most post-World War II US slowdowns and recessions, the current downturn is not just an inventory cycle sparked by a significant tightening of monetary policy in response to rising inflationary pressures. The current slump is the endogenous or spontaneous private sector response to the bursting of the stock market bubble and to excess capacity and falling profitability brought about by an extended period of high and increasingly misdirected investment. The slowdown may therefore well be more

* The views and opinions expressed in this paper are those of the author. They do not necessarily reflect the views and opinions of the EBRD.

prolonged than the short cyclical downturns of much of the second half of the 20th century. The depth and duration of the slowdown will depend crucially on the extent to which the long-term growth rate of US productivity has indeed been boosted. The higher the underlying growth rate of productivity, the sooner profitability and investment will recover.

Western Europe has not known speculative excess, unsustainable demand and over-investment on the scale of the US. The cyclical correction should therefore be milder. Since 1990, Japan has produced a sequence of abortive attempts at recovery, often on the backs of fiscal packages whose stimulative effects got smaller and shorter-lived with each new instalment. The unfinished restructuring of the Japanese banking sector and the financial fragility of the insurance and pension fund sectors are a continuing drag on the revival of consumer and enterprise confidence.

Provided there is no global financial crisis, the prospects for the world economy are better today than some rather pessimistic commentators would have us believe. A global recession is both unnecessary and unlikely. History provides some comfort. The key regional engines of global growth have tended not to all stall at the same time. The Great Depression of the 1930s is a notable exception. The worst global slump of the past 30 years saw annual global output growth at the trough (in 1975) of just over one per cent.

In the US and Europe, and in many of the emerging markets, the scope for the monetary and fiscal policy authorities to respond effectively to limit the depth and duration of any slowdown is better today than it has been for decades.

In the US, inflationary pressures are subdued and, with the stock market nearer rationalizable levels, expansionary monetary measures are possible. With the Federal Funds rate at 5 per cent, there is no serious risk the monetary policy authorities would hit the zero floor on nominal interest rates that would render monetary policy ineffective. The Fed will undoubtedly implement further cuts if confidence and demand continue to falter. The US fiscal position presents no obstacle to the operation of the automatic fiscal stabilisers (the tendency for government revenues to fall and government outlays to rise when the economy slows down). Other fiscal measures, like the tax cuts proposed by the Bush administration, may also turn out to be cyclically appropriate, provided they can be front-loaded more and provided they are targeted at people who will spend their tax cuts rather than save them.

The European Central Bank has price stability as its *primary* objective, not its *only* objective. When actions to sustain economic activity can be undertaken without prejudice to the price stability objective, the ECB not only has the option but, according to its mandate, the duty to do so.[1] We either are in or getting close to that

[1] [1] "…the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 (ex Article 2) of this Treaty." Protocol No. 18 (ex No. 3) on the *Statute of the European System of Central Banks and of the European Central Bank*. Article 2 (ex Article 2) of the Treaty of Amsterdam reads as follows: "The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities referred to in Articles 3 and 4, to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and

situation today, although inflation is still above target. With the ECB' short nominal interest rate at 4.75 per cent, the liquidity trap threat posed by a zero nominal interest rate is remote in Euroland. While the fiscal situation is not as robust as in the US or the UK, there is enough fiscal elbow room to permit the automatic fiscal stabilisers to operate in counter-cyclical fashion. Average general government gross debt stands at about 52 per cent of GDP for all or Euroland, safely below the Maastricht Treaty threshold of 60 per cent. General government financial deficits averaged 2.8 per cent of GDP in 1999, again below the Maastricht threshold of 3 per cent and have declined further since then. The UK, with inflation consistently below target and a strong underlying fiscal position, is capable of responding swiftly and effectively to a significant downturn.

In Japan, the scope for monetary and fiscal policy to sustain or boost aggregate demand is limited. Short nominal interest rates are back at zero. Monetary policy still can target longer term nominal interest rates which remain positive, with 10-year government bonds yielding just under 1.5 per cent. Monetization of longer-term government debt is likely to weaken the yen. Japan's regional and global trading partners should, on balance, prefer a stronger Japanese economy with a weaker yen to a weak Japanese economy with a strong yen. Fiscal policy appears to have lost its capacity to stimulate demand. Tax cuts are saved. The half-life of the stimulus provided by higher public spending appears to be declining steadily. Public debt is the highest in the industrial world and continues to rise rapidly. A Japanese recovery may well have to wait for a spontaneous boost to 'animal spirits', that is, to consumer and enterprise confidence.

As noted earlier, just under half of world GDP and just over 30 percent of world trade is generated outside the advanced industrial nations. Simple arithmetic might therefore lead one to look beyond the industrial countries for a source of sustained demand growth to take over from the USA. However, 46 percent of world GDP and 32 percent of world trade are contributed by 4 newly industrialized Asian economies (who account for 3.3 percent of world GDP and 9.5 percent of world trade), 128 developing countries and 28 transition economies. Many of these countries face severe external and internal debt problems that act as breaks on more expansionary policies. In addition, the odds are low that the uncoordinated domestic policies of 160 countries would add up to an aggregate demand stimulus that would be globally appropriate. Effective co-ordination of an economic orchestra with 160 aspiring soloists would also be a difficult task – one that is beyond the capacity of existing institutions and arrangements for surveillance and co-ordination. This leaves 86 percent of the world's population in countries that play no conscious or active part in attempts to dampen the global business cycle.

International Financial Crises: Prevention and Cure

The slowdown and recession scenarios considered thus far are based on the assumption (and hope) that there will not be a global financial crisis: key stock and bond markets will remain liquid and maturing debt can be re-financed or rolled over

---

women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States."

by solvent borrowers with good financial track records. There is no panic, no desperate flight to quality.

Recessions can occur without being triggered by and without triggering financial crises, domestic or international. Financial crises need not cause recessions. But when a recession collides with a financial crisis, ugly things can happen.

There are five features of the current international financial system that make crises both more likely and more costly.

(1) Episodic financial market inefficiency. International financial integration or financial globalisation has many advantages. International capital mobility allows private and public saving to be allocated to the globally most productive investment projects. Foreign direct investment bundles expertise, technical know-how, managerial and entrepreneurial skills with the acquisition of an active or controlling ownership stake, to the benefit of all involved. International trade in contingent or risky claims, including the recent explosion in derivatives trading, allows risk diversification and risk sharing to occur on a global scale. Finally, the threat of a run on the currency and a rising sovereign risk premium can exercise a restraining influence on reckless or incompetent governments.

However, these fruits from financial globalisation are not automatic or universal.

The signals given by financial market prices are only as good as the forces that drive them: the information, expectations, risk aversion, prudence, impatience, moods, prejudices, hopes, fears and phobias of market participants, weighted by their ability to mobilise resources. At irregular intervals, waves of irrational exuberance or despondence sweep through financial markets. Myopia and herd behaviour, and in the limit, hysteria and panic, drive market valuations away from fundamentals.

Good things happen when trade in contingent, risky, claims transfers risk towards those more willing and able to bear it and away from those less willing and able. At times, however, risk is traded to parties most willing but quite unable to bear it. This misallocation may reflect ignorance or dishonesty and fraud. When disorderly, illiquid markets prevail, the financial market system not only fails to allocate the unavoidable global risk efficiently, it creates additional, avoidable risk, through costly defaults and bankruptcies and unnecessary economic dislocation.

(2) Inadequate regulation and supervision

The reach of private financial capital is global. The span of control of regulatory and supervisory authorities is national.

Lack of information about cross-border off-balance sheet exposures is an endemic and increasingly systemic problem. One only has to point to the astonishing growth of derivatives trading, much of it ‘over the counter’, and much of it involving multiple national jurisdictions, and to the almost complete lack of information about the exposure of financial institutions and other players in the derivatives markets. There are also untested and therefore unsettled issues concerning the legal enforcement of many of the new contingent claims.

(3) No global lender of last resort. There is no global lender of last resort or some analogous arrangement for providing unquestioned liquidity in unlimited amounts and at little or no notice. Contingent credit lines with IFIs or with private financial institutions, can compensate to some extent for the absence of an international lender of last resort. Pre-qualified countries now can have such arrangements with the IMF. Both the number of countries and the amounts of money involved in such arrangements are limited

.

(4) Ineffective sovereign debt default work-out arrangements. There is no effective mechanism for orderly default workouts for sovereign borrowers. There is no analogue in the case of cross-border sovereign borrowers to the reasonably effective domestic mechanisms for encouraging more efficient bargaining between domestic creditors and debtors, such as Chapter 11 in the USA. The result is that costly defaults occur too often and that debt work-outs are delayed unnecessarily.

(5) Moral hazard in existing ad-hoc arrangements for dealing with local and regional financial crises.
There is no effective rule-based mechanism for preventing crises and for mitigating the consequences of international default, including clear rules for burden-sharing among debtors and creditors. The international community has instead tried to cope with emerging market crises through a sequence of *ad-hoc* packages, typically put together by the IMF with the support of the G7, involving bilateral and multilateral financial support, rescheduling of outstanding debt, new money, fiscal retrenchment, changes in the monetary and exchange rate regime and structural reforms. Critics argue that such packages contain an element of creditor bail-out. The expectation that such packages will be available should a crisis hit encourages excessive risk-taking by creditors - gives rise to *moral hazard*. The immediate crisis is resolved at the cost of making future crises more likely and more expensive.

Conclusion

Downturns and recessions, just like upswings and booms, are unavoidable features of a market economy. Even if we escape in 2001, recessions will strike sooner or later. Our ability to prevent financial crises remains limited, as are the institutions and tools for minimizing their impact. Deep recessions, depressions and persistent financial crises can be avoided, even with the imperfect institutions and policy instruments currently at our disposal. The authorities have the tools, the knowledge and the mandates to prevent anything worse than rather mild recessions. When a recession is compounded with a financial crisis and aggravated through misguided monetary, fiscal and protectionist policies, the floor can be a long way down. Such calamities, however, are not an act of God, but the outcomes of perverse policy choices.