Euro Crisis & World Economic Outlook

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US Financial Shocks to Global Economy

In 2007 and 2008 the US economy was the epicenter of global financial shocks. A massive bubble in US residential real estate burst in 2007, with huge negative consequences for homeowners and for financial institutions. As is well known, the primary engine of US economic growth had long been household consumption, accounting for more than two-thirds of GDP. What was less recognized was that savings of households were mostly embodied in the value of their homes. When home values fell, consumption began to weaken. When home values fell, major mortgage lenders found themselves in difficulty. Many of these lenders were banks, and they responded by curtailing credit. Household consumption weakened further in the absence of additional credit. A recession began, catching many other economies around the world in its grip.

Large financial institutions also began to falter, as large parts of their portfolio of loans became non-performing. As large banks became troubled, a slow-moving contagion of credit tightening spread across the Atlantic and the Pacific. At first, Federal Reserve and Treasury officials thought the weakening of housing would be temporary and not have a major impact on the rest of the economy. As the financial credit crunch spread, it became apparent that something much deeper was at work. It turned out that mortgage lenders had learned to bundle mortgages into new securities, which they sold to nonbank institutions like pension funds, sovereign wealth funds, insurance companies, university endowments, and hedge funds. These securitized assets, known as asset-backed securities (ABS), were also converted into additional types of esoteric securities known as derivatives. What this meant was that the collapse of mortgage-backed securities had severe repercussions on investment banks, pension funds, and other investors. Worse, it became apparent that many large banks kept many of the ABS assets in hidden, off-balance-sheet positions known only to accountants but not publicly disclosed. Many of the larger banks found themselves with assets that were rapidly declining in value. Banks stopped trusting each other, cutting lending to each other. Since many banks around the world depend upon short-term, low-interest loans from each other and from other lenders like money market funds, the liquidity of the financial markets dried up.

Global Recession

This financial deterioration did not remain contained inside the US, but spread throughout the world, with a heavy impact on European and Asian financial institutions. What followed was the longest, deepest recession the world had experienced since the 1930s.

Ironically, although the US was blamed for bringing the financial crisis, the first major international bank to suffer risk of collapse was not a US bank, but rather BNP Bank in France, on August 9, 2007. The financial market deterioration continued for more than a year, culminating in the collapse of Lehman in September, 2008. The US government and the Federal Reserve decided not to bail out Lehman when it ran out of operating funds. Instead, Lehman was allowed to collapse. In parallel, world credit markets crashed with such severity that even trade finance came to a halt. It was discovered that interconnectedness of banks throughout the world was so great that the collapse of even one major financial institution had massive effects virtually throughout the entire network of international banking. World trade fell abruptly in the final quarter of 2008 and in 2009 the decline in world trade was about 25%, resulting in the longest, deepest contraction of world trade since the Great Depression. This steep fall in world trade had its most severe effects on China and other export-dependent emerging market economies.

Excessive Financial Leveraging to Boost Economic Growth

How had this happened? There are many reasons for the failure of financial markets, but the most important was a decision taken in the 1990s by government officials in Washington and some other capitals to allow banks to increase their leverage. It was argued by top US officials that banks were no longer holding risks but instead were repackaging their risky loan assets and selling them to third parties as asset-backed securities. It was argued that this securitization of the financial assets of the country meant that banks were no longer holding great risks, and could be allowed to increase the ratio of loans and trading activities to their capital base. Banks in the US and Europe escalated their leverage from traditional levels of 10 or 15 times capital to ratios of up to 60 times capital in some European banks and 40 to 50 times capital in some US banks. Thus, we found our world immersed in leverage. Households were leveraged in holding high-value homes with small equity investments, and banks were leveraged in issuing and holding vast loans and trading positions against small capital. Borrowing became the driver of modern economies, not only in the US, but around the world.

Temporary World Economic Recovery from Government Actions

In 2011 there were signs of moderate improvement in world trade, and in many national economies. Governments in the US, Europe, and Asia had come to the rescue through fiscal stimulus, monetary expansion, and pressure on banks to increase lending. However, this process of stimulating economic recovery brought with it greater government borrowing, to fund growing budget deficits. The ratio of government debt to GDP escalated in many nations, most particularly in Western Europe.

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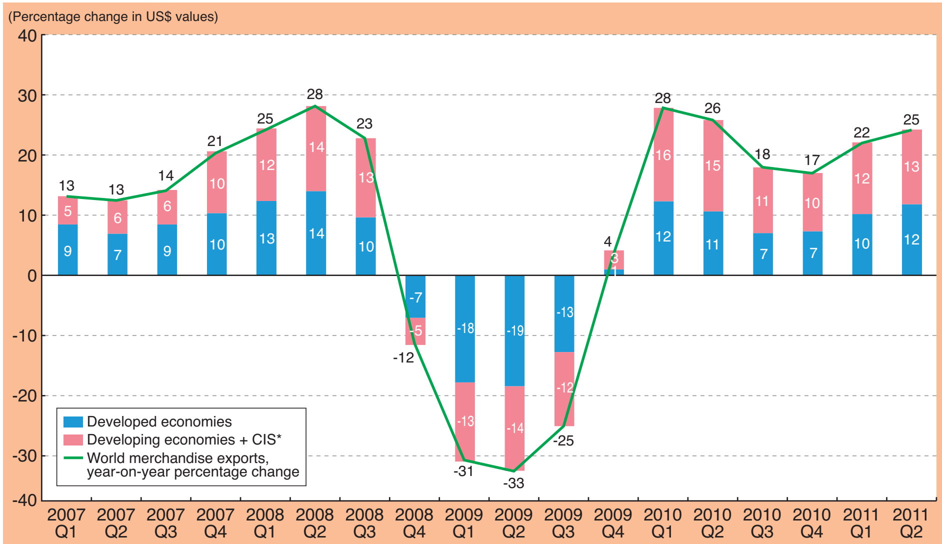
Contributions to year-on-year growth in world merchandise exports, 2007Q1-2011Q2



**Includes significant re-exports.*

Note: Due to scarce data availability, Africa and Middle East regional totals are under-represented by about 5% and 10% respectively.

Source: WTO Secretariat estimates, based on data compiled from IMF International Financial Statistics; Eurostat Comext Database; Global Trade Atlas; and national statistics.

New Shocks with Epicenter in Europe

In September, 2011, the world again faced another round of financial shocks. The epicenter this time was in the Eurozone. Ironically, BNP Paribas was again on the edge of failure, along with Societe Generale and Credit Agricole in France. Dexia Bank in Belgium collapsed and had to be rescued by a combination of the governments of France, Belgium and Luxembourg. Banks in Italy, Spain, Portugal, Ireland, Austria, Belgium, and others felt extreme distress. Interbank lending again dried up, but this time the credit crunch seemed confined to the Eurozone. Government sovereign debt was suffering from lack of demand by investors, so interest rates rose sharply. Greece became the focal point of financial crisis management, with the growing possibility of default. German leaders demanded that Greece involve the participation of private bondholders in sharing the burden of financial rescue. The troika of IMF, EU, and ECB together insisted on “haircuts” on Greek government bonds, so that investors would share with taxpayers the costs of another rescue. Negotiations of private-sector sharing of cuts in the value of their bonds have proven difficult. Inside Germany, the strongest economy in the Eurozone, the majority of voters oppose further bailouts to high-deficit economies like Greece, Spain, Portugal and Italy. The German government, pressed by its voters, is now demanding fiscal austerity in fellow Eurozone member nations. This means deeper cuts in public spending and higher taxes, pulling several euro member countries back into recession, or even deep depression.

Europe Enters Recession

The 2012 outlook is for the Eurozone to slide into more severe recession, with financial crises likely to damage European banks even more severely than the troubles experienced in the US with Lehman and a few other major US financial institutions. Portugal is in almost the same predicament as Greece, except a few months behind the Greek timetable. Ireland had received a rescue package from its fellow Eurozone members last year, but politicians in Ireland are now demanding that Ireland also get a “haircut” on its government bonds held by investors in the rest of the Eurozone and elsewhere around the world. The sovereign debt of Spain and Italy is being rejected by investors, resulting in rising interest rates that assure increasing shares of future government revenues must be paid out to investors before being used for domestic social support.

The European Central Bank (ECB) has tried to relieve the negative pressures at work in the Eurozone financial market by buying small amounts of sovereign bonds of member governments. Since late last year, the ECB also offered to increase the length of its short-term loans to Eurozone banks to three years, and to relax the criteria for collateral provided by banks in exchange for euros loaned for these three years. (This program is known as Long-Term Recovery Operations, or LTRO.) While Eurozone banks still refuse to lend to one another, they are able to take their holdings of sovereign debt of Eurozone governments, and other types of business loans, and submit these assets to the ECB in exchange for cash with only a slight discount. Essentially, Eurozone banks can bring assets worth much less than their face value to the ECB and receive in return almost full face value in the form of euros. This has created an illusion that the Eurozone economies are being rescued and that financial crises have been avoided. In reality, bad assets have simply been moved from banks to the ECB, which is now sitting on huge holdings of deteriorating and nonperforming debt.

European Governments & Banks under Stress

Underlying the confused, stressful European financial markets is the dark reality that many, perhaps most, Eurozone banks are extremely leveraged and therefore at risk of collapse. Eurozone governments are now pressing their banks to increase capital, in order to shrink their ratio of assets to capital. Because of collapsing stock prices, short-term funding freezes, and warnings of investor and depositor loss of confidence, some banks and governments in Europe are engaged in emergency planning (the French government is in crisis talks with its three biggest banks). Some Eurozone and Swiss banks are as big as or bigger than the GDP of their countries, raising the dark shadow of an "Iceland effect." This threat is forcing consideration of dramatic downsizing of some of the biggest banks in the world.

Eurozone banks are finding it difficult to find new investors without deep discounts in new share issuance, so they are instead resolving the request of their governments to shrink leverage by shrinking loans and credit lines, and by selling off lines of business they have maintained for many years in other economies around the world. The result is a massive credit contraction globally, with particular impact in emerging market economies that have long relied on ample lending by Eurozone banks.

Weak Global Recovery

Thus, in 2012, the world still finds that it is caught in a massive process of deleveraging. This process of deleveraging appeared to begin in the US, but it is now apparent that it is a process that is also under way throughout Europe, with effects spreading to Third World economies. Ordinarily, the IMF might be counted on to help offset financial market distress in the emerging economies, but the IMF has tied itself to very large commitments in assistance to the Eurozone member governments, leaving only a small fraction of its available resources for the most needy emerging market economies. The IMF has just requested its member governments to consider voluntary additional deposits with the IMF to strengthen the IMF's resources. The US has already said it would not participate in this voluntary expansion. Some of the governments of other major economies are raising questions about whether the IMF priority attention to Eurozone rescues is appropriate, given the apparent needs of poorer economies during the likely world financial stresses in the future.

Slowdown in World Trade

In the background, little attention has been given by most analysts and by the press to the hard reality that world trade has not really recovered from the financial crises and recessions of 2007-2008. As noted earlier, world trade collapsed alongside Lehman in September, 2008. Then world trade continued contracting throughout 2009. In 2010 world trade began growing again, but by early 2011 the level of world trade had again only barely reached its previous peak of August, 2008. However, world trade showed little positive momentum in 2011, and at the start of 2012 it has become evident that world trade is growing only very slightly, if at all.

To comprehend the significance of this long downturn and feeble recovery in trade, one must reflect on the last six decades, or most of the period since the end of WWII. In most of those years, world trade grew almost twice as fast as world production. This provided the opportunity for economies with weak domestic consumption to grow more rapidly by shifting the emphasis to exports. More and more economies became export-dependent, including not only emerging market economies, but also economies like Germany and Japan. Now, in 2012, world trade looks to be in near-stagnation, at a level reached just before the Lehman crisis of September, 2008. What this is telling us is that world demand is less than world manufacturing or industrial capacity. So growing an economy out of financial crisis and recession through increased exports is not a viable option. President Obama last year promised to double US exports over the next five years in order to lift the US GDP. This was a promise that is unlikely to be achieved. No country can grow its exports in the present slump in world trade without taking market share away from other nations. We should have learned from history that pursuing increased market share by taking market share from other nations is a path to an even deeper economic downturn.

As explained at the outset, the epicenter of world financial market distress was in the US in 2008. At this moment, the epicenter of world financial market distress seems to be in the Eurozone. Underlying these financial market challenges are two more fundamental forces: weak global demand, which means inadequate growth in world trade; and necessary financial deleveraging of both governments and banks, which means contraction of consumption, further bank crises, and a lengthy period of recession or economic stagnation in many countries. The recent lowering of economic growth forecasts by both the IMF and The World Bank are a warning, because in their lowered forecasts both have warned that downside risks are great, with potential for even slower growth or deep recession.

Consequences for Export-dependent Economies in Asia

What are the consequences of this challenging outlook for the economies of Asia? First and foremost, it cannot be assumed that export demand will be strong enough to pull China, Japan, and other Asian exporters out of a prolonged period of weak, disappointing economic growth. China has already ceased to be competitive in many of its high labor-content, low value-added exports. China must now find ways to step up domestic-driven growth. Internationally, China will need to shift to lower labor-content, higher value-added exports or to basic infrastructure projects to be sold to emerging market economies. Japan must find a way to work from an unnaturally high yen valuation to extend its global economic footprint, through globalization of both manufacturing and financial and R&D services. South Korea and Taiwan are already moving rapidly up the value-added ladder but an even faster pace of adjustment will likely be necessary. Even resource-dependent economies in Asia will have to think innovatively as demand for non-renewable resources remains on a weaker growth path than was experienced in the last few decades.

The financial crises that begin in the last decade have much further to run, and necessary further deleveraging will mean weak global demand well beyond this year, and perhaps for several years into the future. JS

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