Risks for the world economy

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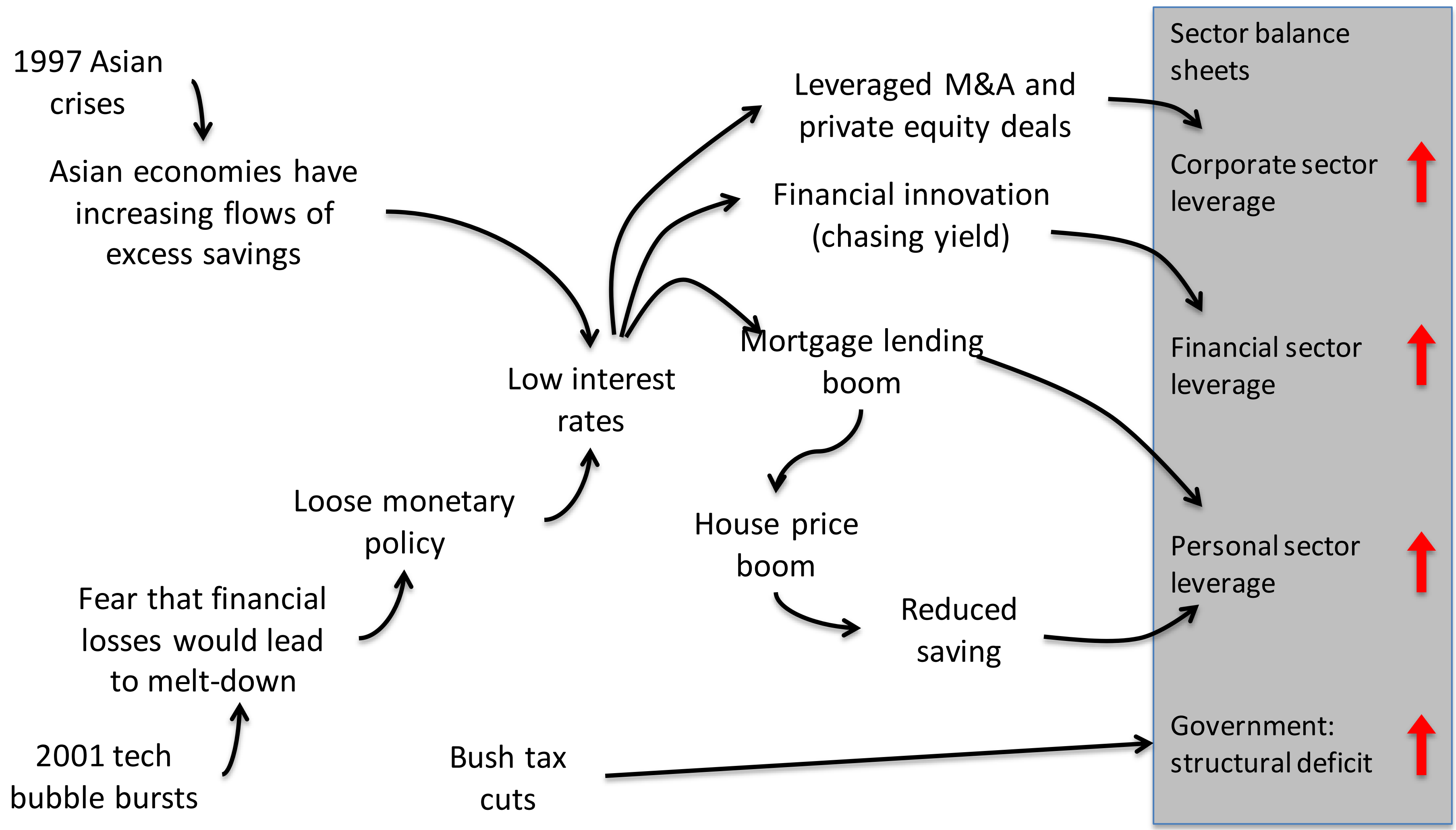
The World That Was

- ► **Globalisation**
- ► **Technology**
- ► **Deregulation**
- ► **Great Moderation**

- ► High Trend Growth – OECD (AS) and BRICS
- ► Low inflation, Restrained wages
- ► Low volatility
- ► Low interest rates – short and long
- ► Strong Profit Performance
- ► Attraction of Debt Finance
- ► Advisory work and M&A

From my colleague Andrew Scott wonderful teaching slides

The build-up leading to the 2008 crisis is complex



…. a big part o the story is the accumulation of leverage in developed markets (DM)

The World That Is

Six years after the global recession

- ➢ **Worldwide recovery**
- ➢ **Tranquil financial market**
- ➢ **Low inflation and low interest rate**

Are we back there? Perhaps but …

- No stabilization of debt worldwide
- Large debt overhang in the euro area and increasing debt in emerging markets
- Slowdown in projected potential output growth in the US and the Euro Area especially
- New bubbles possibly developing

How did we get from 2008 to 2014 and what does this imply for the outlook?

With a disclaimer …

"How frustrating. The crystal ball is down again."

US and the euro area: the adjustment

- The policy response in the two economies was very different and so has been the result

- The challenges ahead are also different but some common threat …

The US

- It did adjust (political will/'political infrastructure' to force through bank recapitalization, plus accommodative fiscal policy ..) and is consequently now in much better shape (not only faster growth trajectory … but also less danger of another balance sheet recession)
- The adjustment was done via a redistribution of the burden from private to public balance sheets, both fiscal and monetary authority

This carries some risks: low interest rate fueling new bubbles, public finance sustainability, exit from QE …

The Euro area

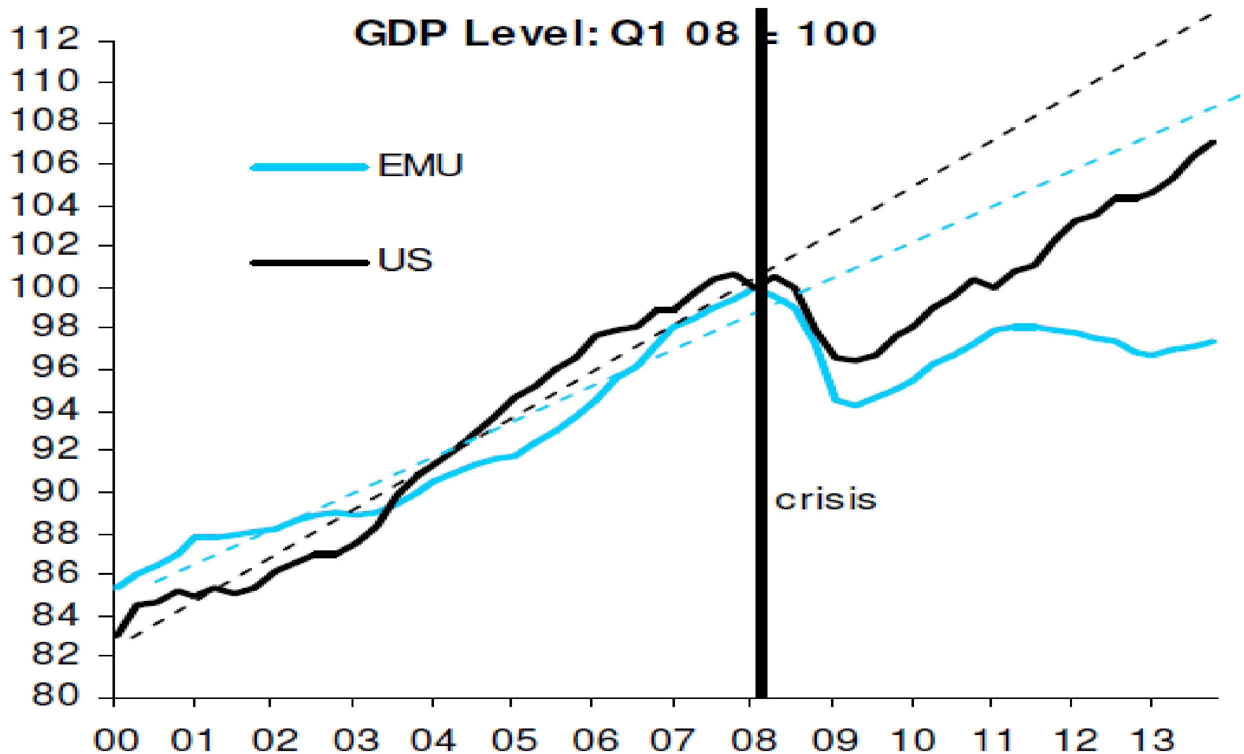
- By contrast the EA did not adjust (lack of political will/political institutions, plus complicating factor of bank-based financial intermediation) .. which led inevitably to the interdependency between bank and sovereign risk and the broken transmission mechanism for monetary policy
- Now we have the (terrible)combination of (1) continuing debt overhang, (2) restrictive fiscal policy, (3) endemic low growth .. and hence the threat that, when the next accident happens, there will be another balance sheet recession

Different risk: low growth because of excess saving (financial repression) leading to either stagnation or new debt crisis

The real economy

The Euro Area had a larger loss of income than the US since the crisis although the initial income shock was of similar magnitude but neither economies are back to trend

Figure 4.2.11



Source: authors' calculations based on national accounts data.

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The US in more details

- Large shock on households' assets related to collapse in housing prices leading to deleveraging and increase in saving
- Early deleveraging by banks (recapitalization at an early stage)

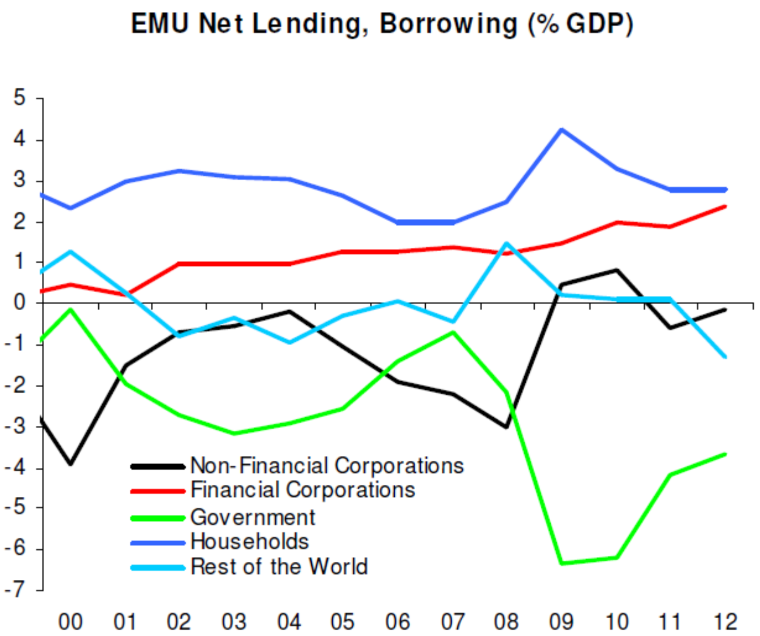
The increase in private saving was compensated by a decrease in public saving explained by aggressive fiscal policy in the early stage

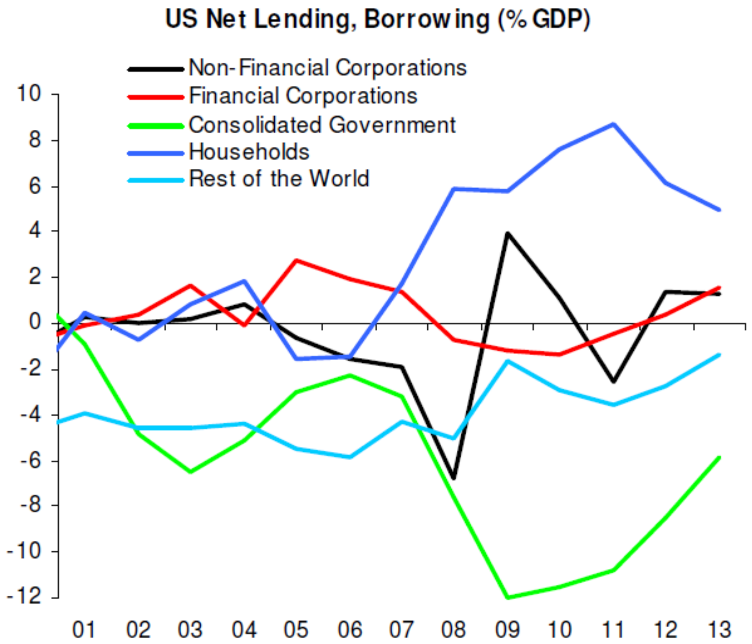
- Aggressive monetary policy led to a rebound in asset prices
- By 2011 private balance sheet repaired but increase in public debt

The Euro Area in more details

- Gross debt to GDP ratios in all sectors stabilized but not decreased
- No significant drop in households’ assets
- No deleveraging by banks until recently
- Limited fiscal stimulus and emphasis on fiscal consolidation
- Monetary policy acted in a vacuum and eventually lost effectiveness

The Euro Area and the US Sectoral Flows





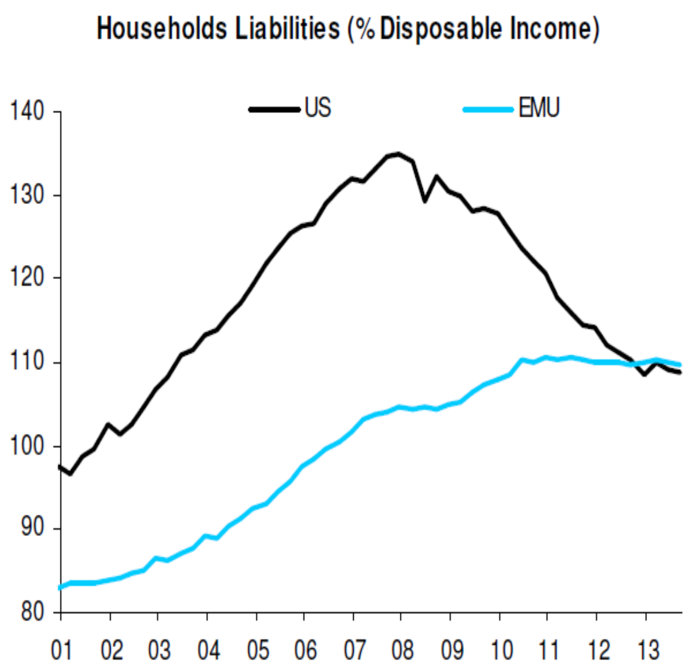
In the Euro Area most of the adjustment is in non-financial corporations

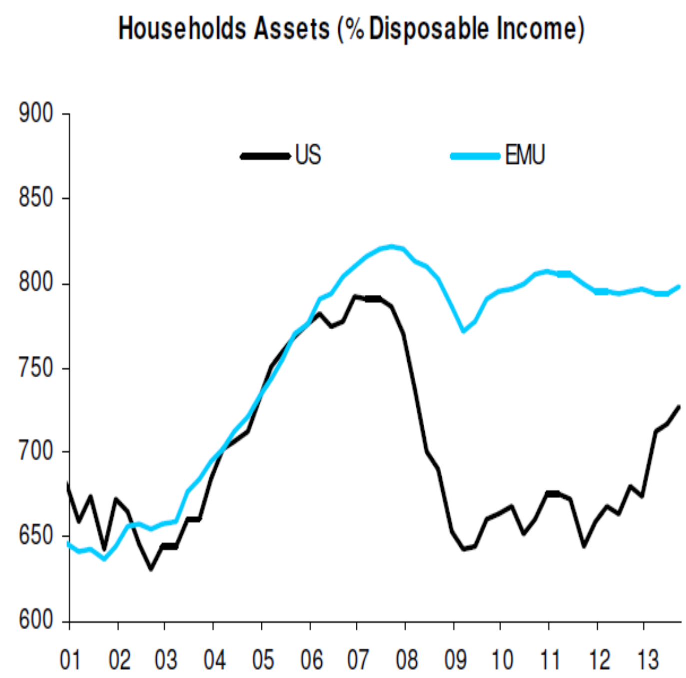
Increase in households' savings mirrored by a decrease in public saving

The Euro Area and the US: the stocks

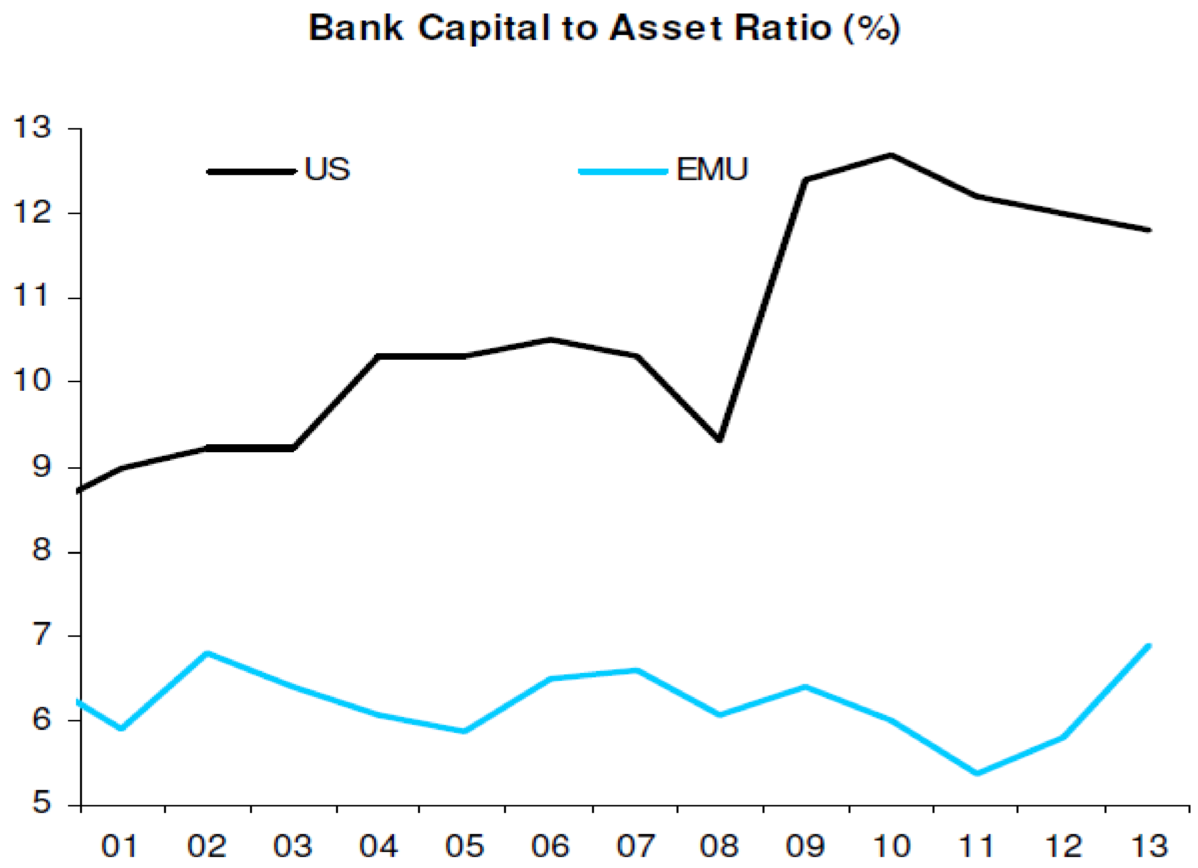
households' liabilities and assets

Figure 4.2.3



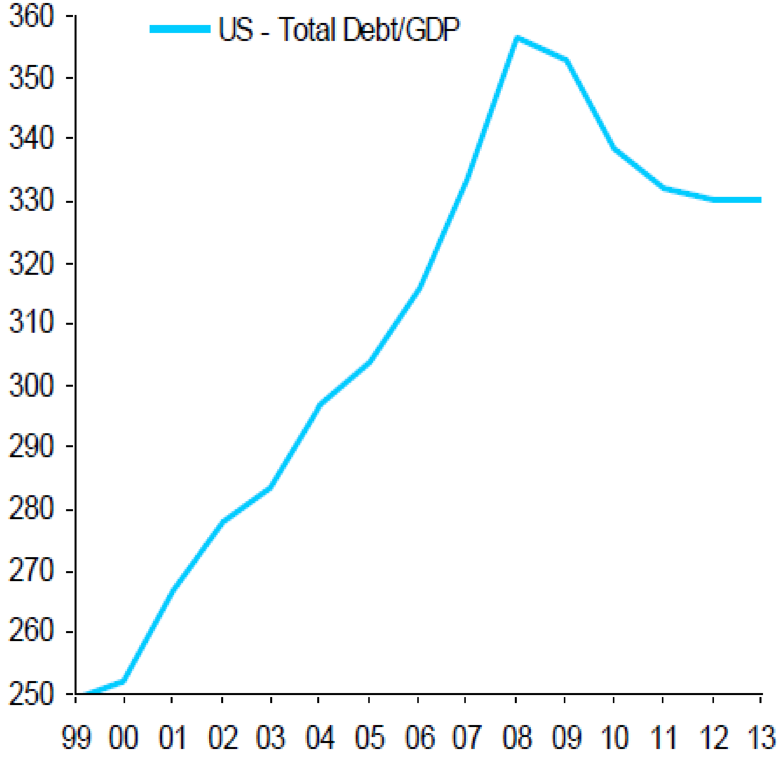


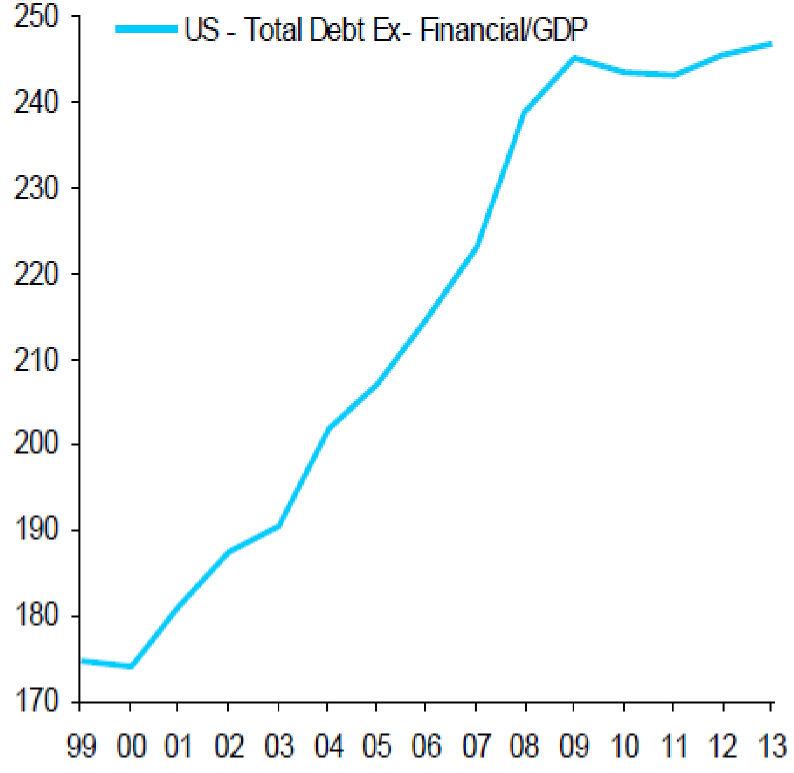
The Euro Area and the US delayed deleveraging by banks



Source: authors' calculations based on FRED, ECB and FRB data

The US: stabilization achieved





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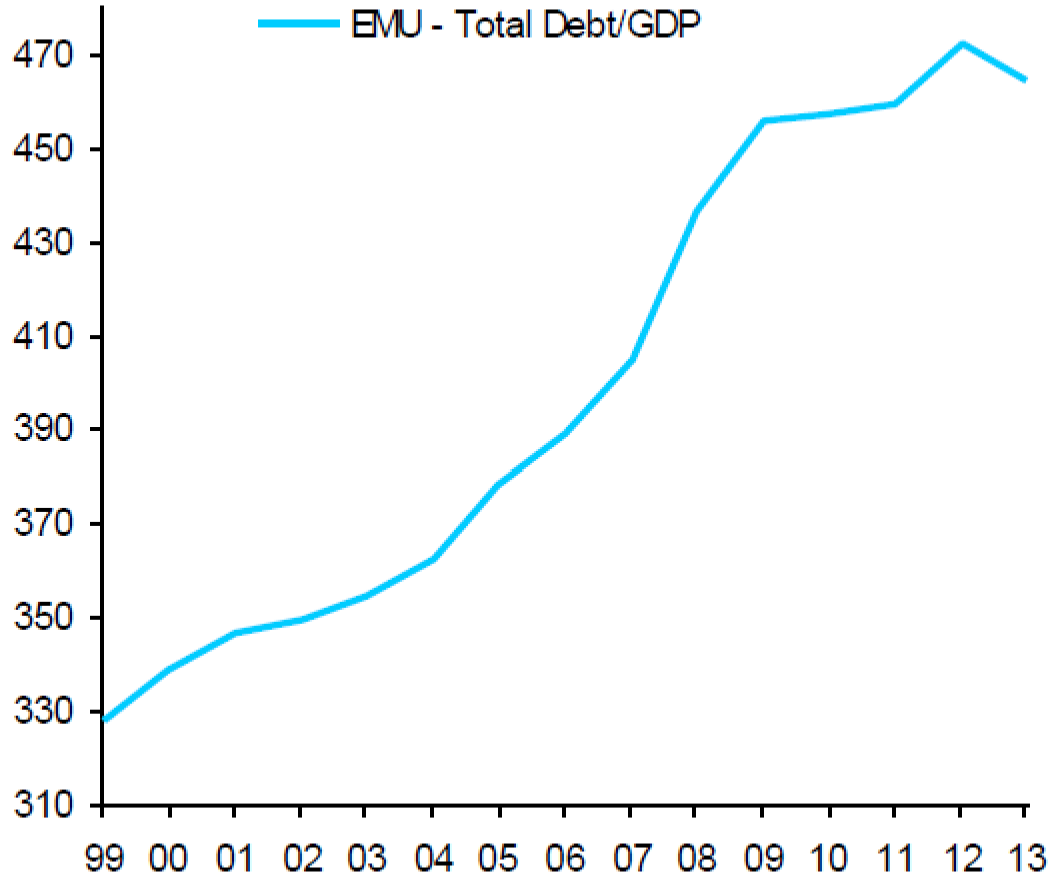
The EU: deleveraging has only started



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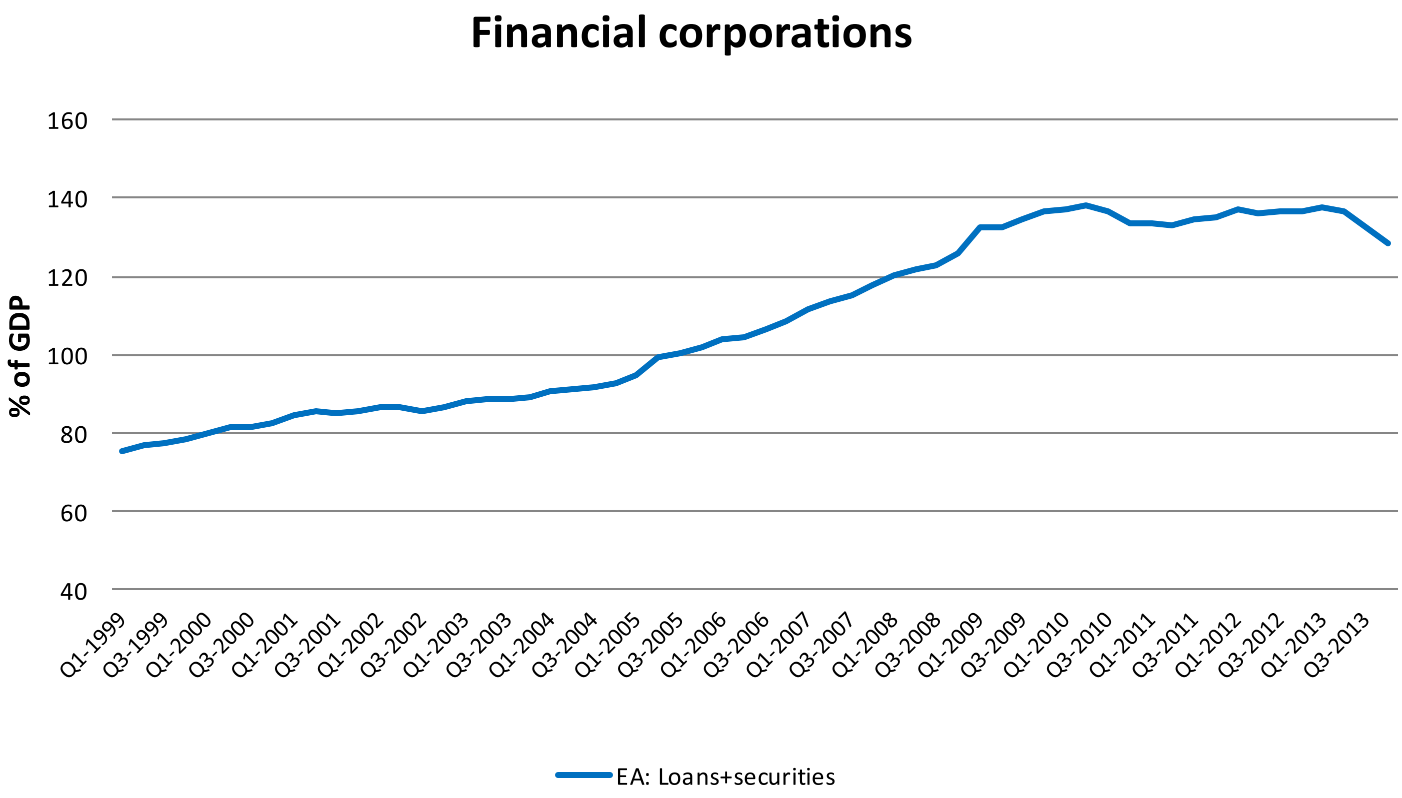
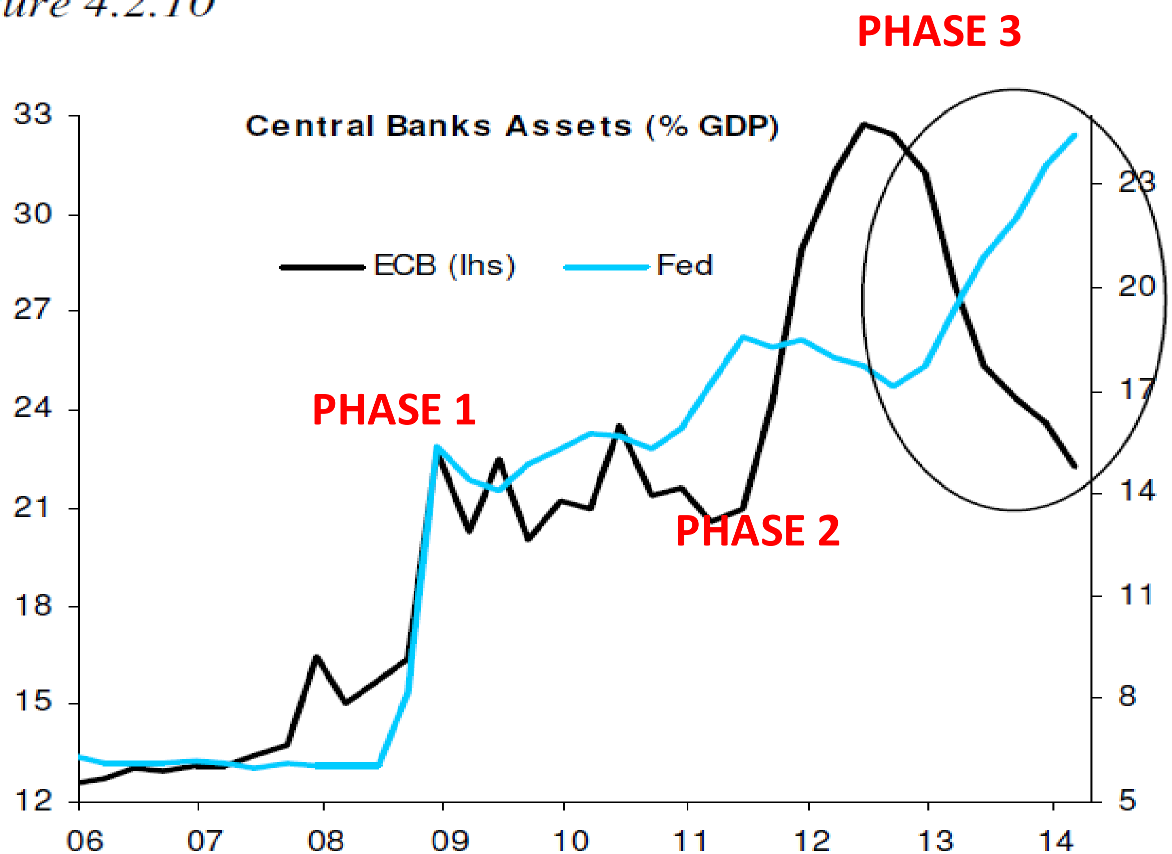
No deleverage of the financial sector until recently



Monetary Policy

Figure 4.2.10



Source: authors' calculations based on ECB, FRB and national accounts data.

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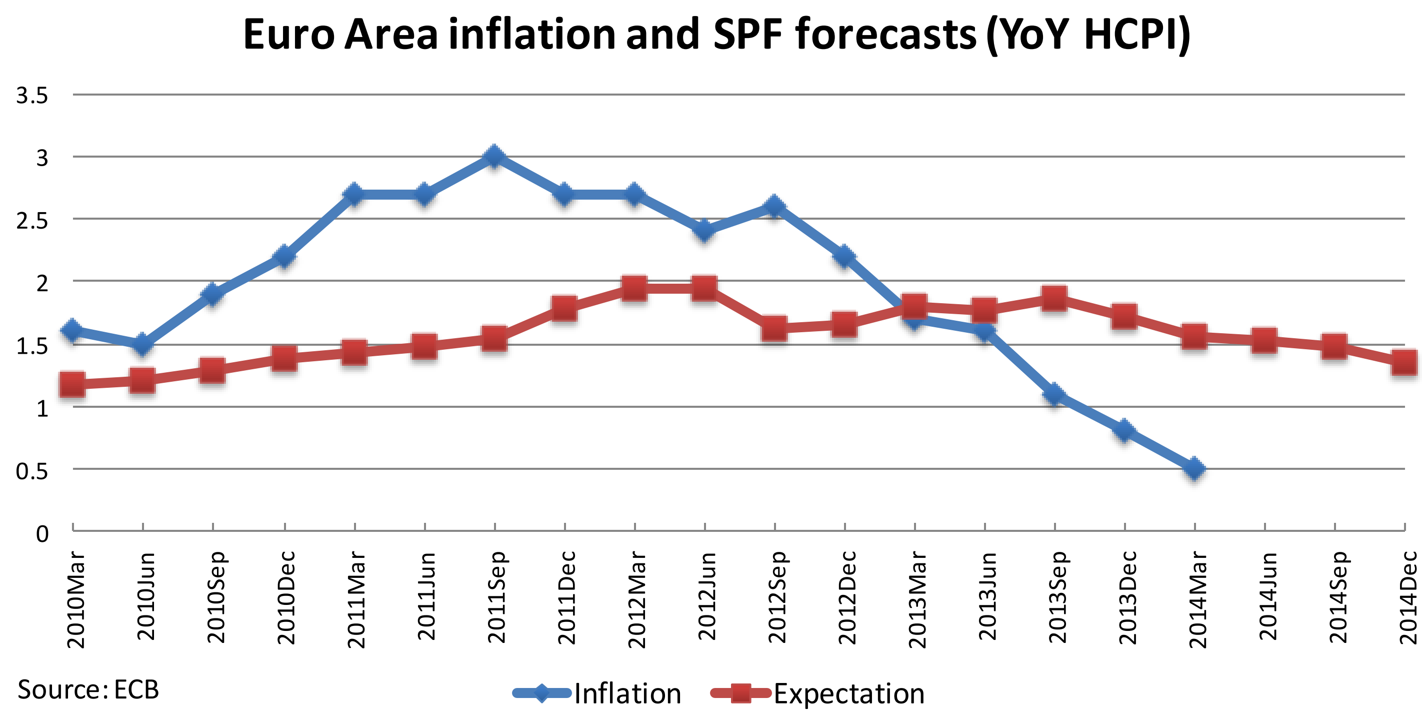
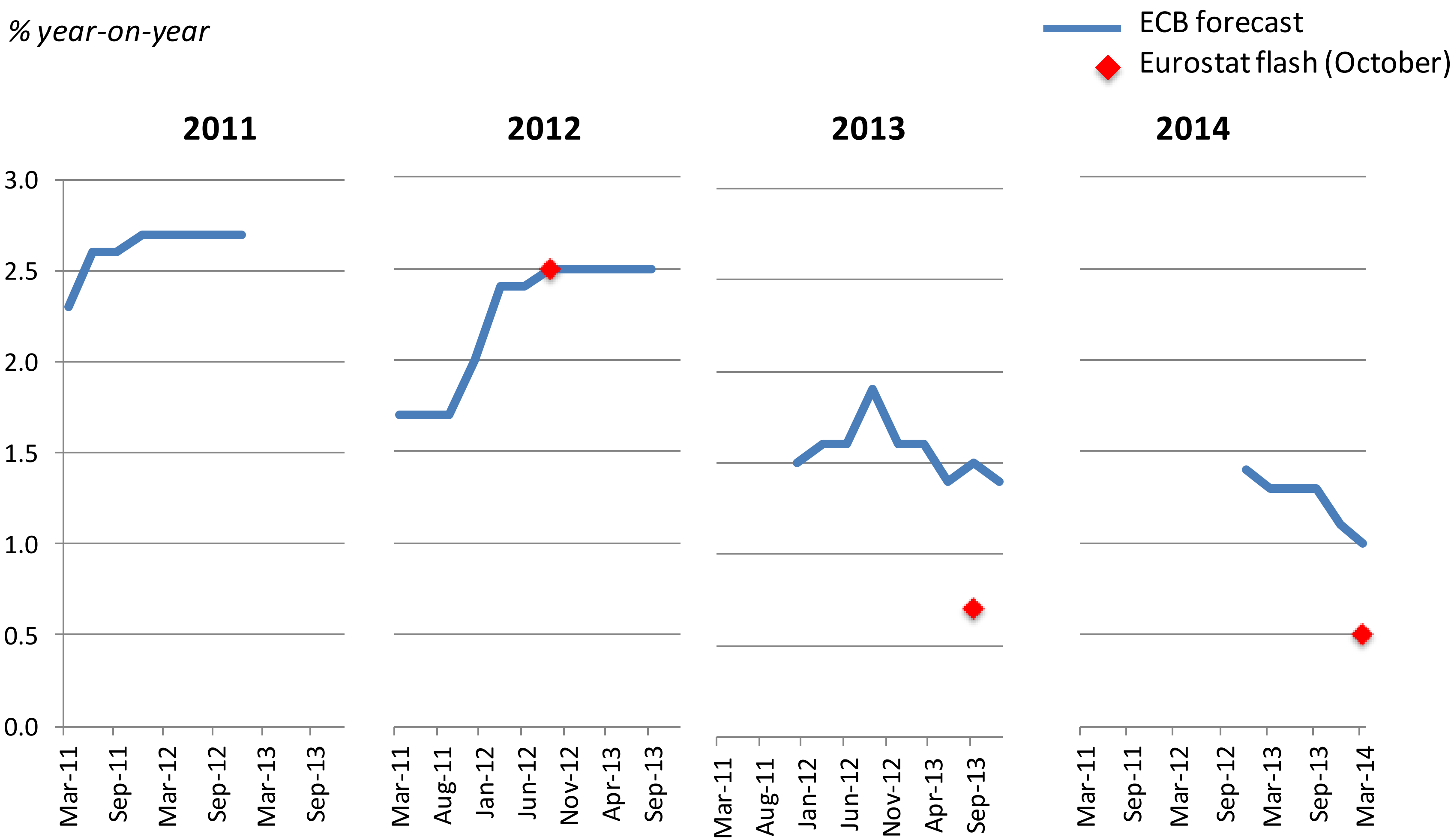
In this situation inflation in the euro area declined unexpectedly: lower than market expectations



Source: ECB

… the ECB also surprised



Sources: ECB, Eurostat

Different challenges for the US and the EA

For the US:

Protracted low interest rate and no fiscal consolidation sustain a recovery which is driven by a new bubble and masks the risk of a new debt crisis ahead

For the EA:

Fiscal consolidation and unsupportive monetary policy has led to a structural weak demand implying external surplus and financial repression reminiscent of Japan

Financial Repression in the EA explains low risk premia but weighs on growth

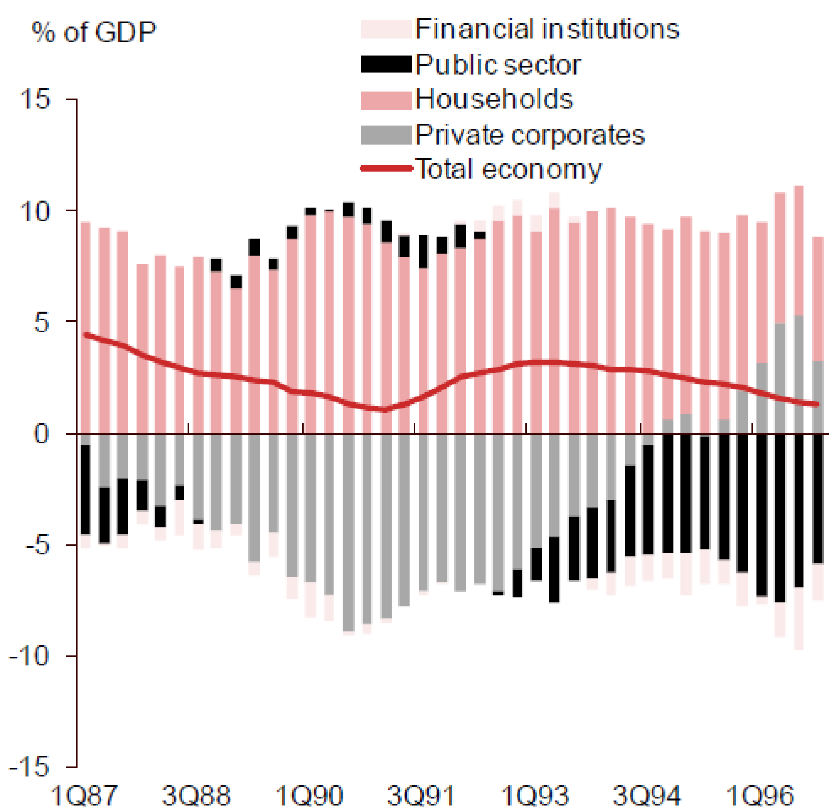
- Contraction of aggregate demand and external surplus
- Balkanization of the financial system leading banks and other financial institutions to invest in their own sovereign
- Change in asset composition away from loans and towards domestic sovereign
- Collapse in consumption (and decrease in housing savings)
- Compensated by increase in corporate savings

… as in Japan in the 90s

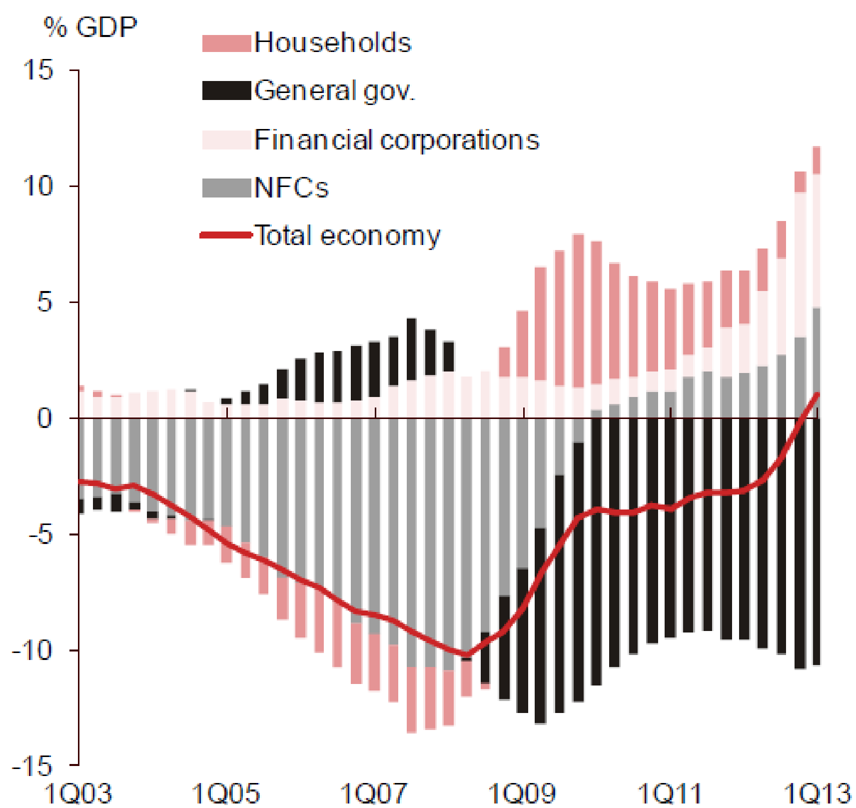
Spain and Japan

Corporate sector in Japan and Spain show very strong similarities

Japan



Spain



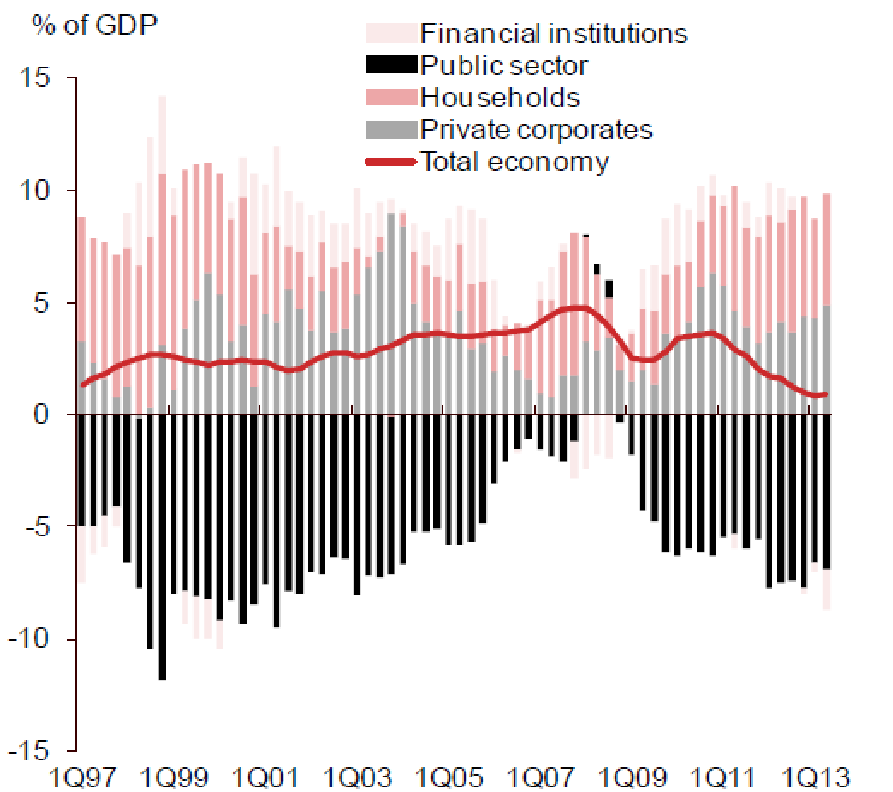
Source: Bank of Japan, ECB and Nomura Global Economics

Jacques Cailloux, Nomura

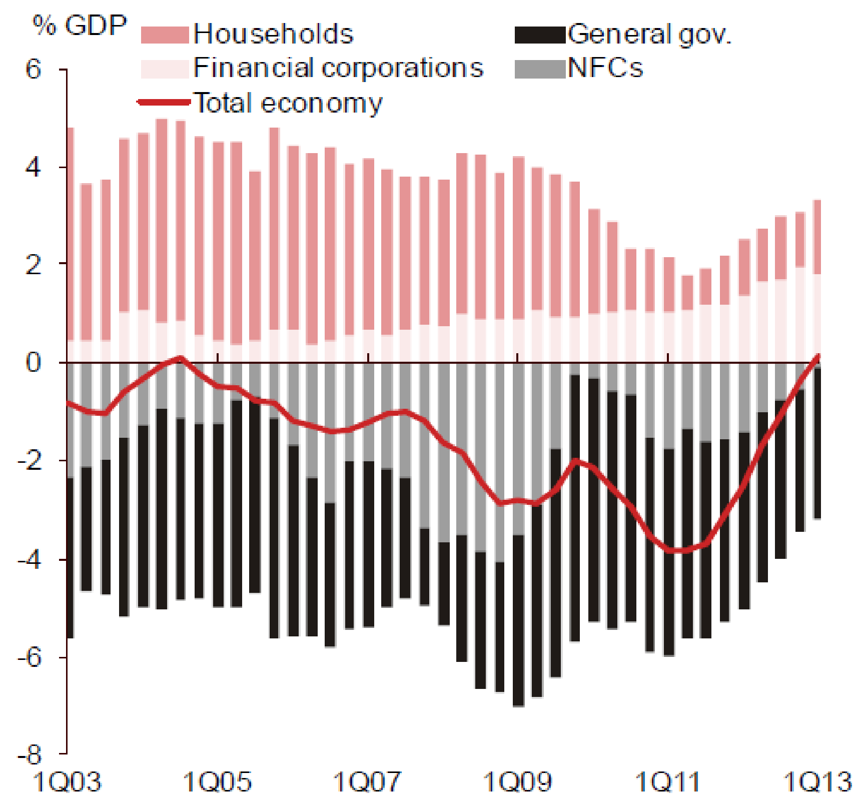
Italy and Japan

Italy has reached self financing situation thanks to turnaround in corporate behaviour (financial and non financial)

Japan



Italy



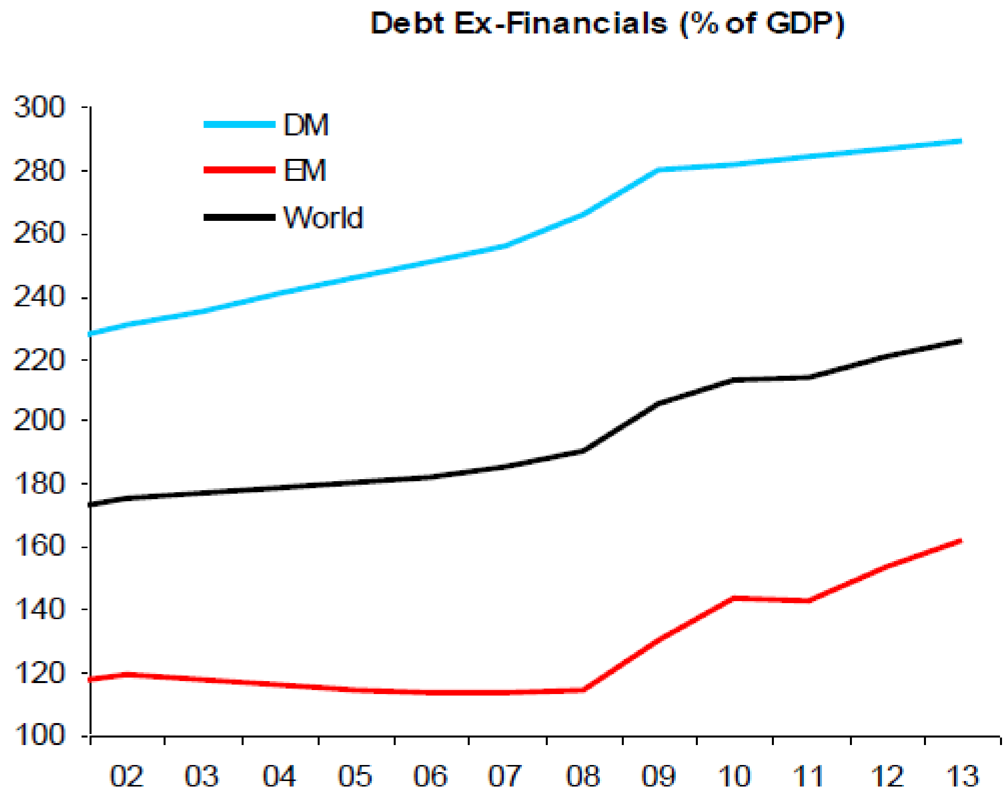
Source: ECB and Nomura Global Economics
Note: Ratios are calculated as the 4q moving averages of sectoral data over 4q moving averages of nominal GDP.

Jacques Cailloux, Nomura

Emerging markets and China

- Although EM were less leveraged than DM prior to the crisis, they have continued to leverage up since then
- This explains the increasing leverage worldwide driven in particular by China

Debt growth has moved to emerging markets



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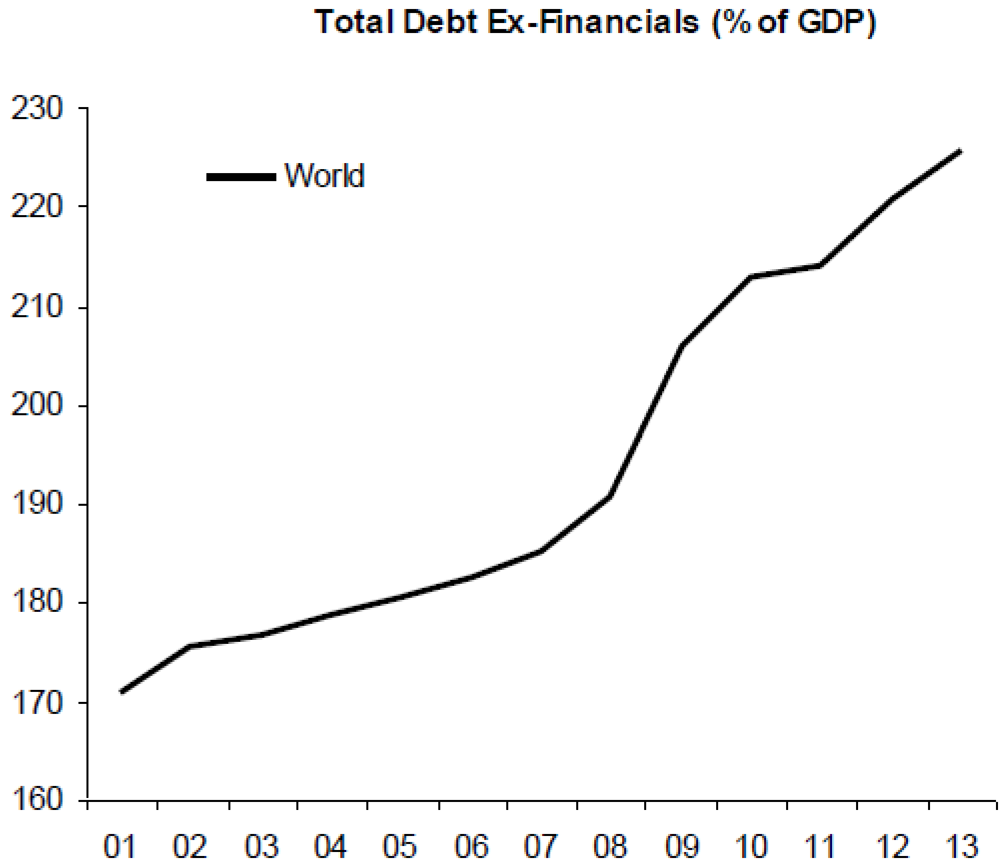
This is why world debt keeps growing



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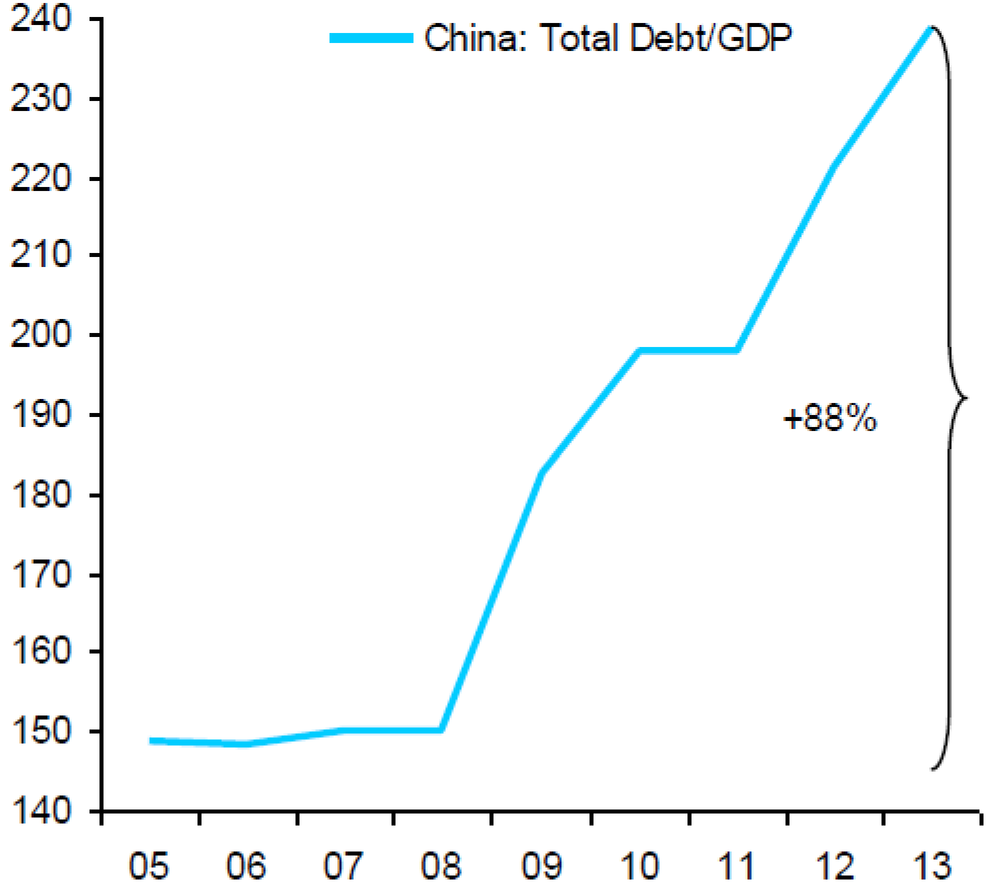
In particular in China



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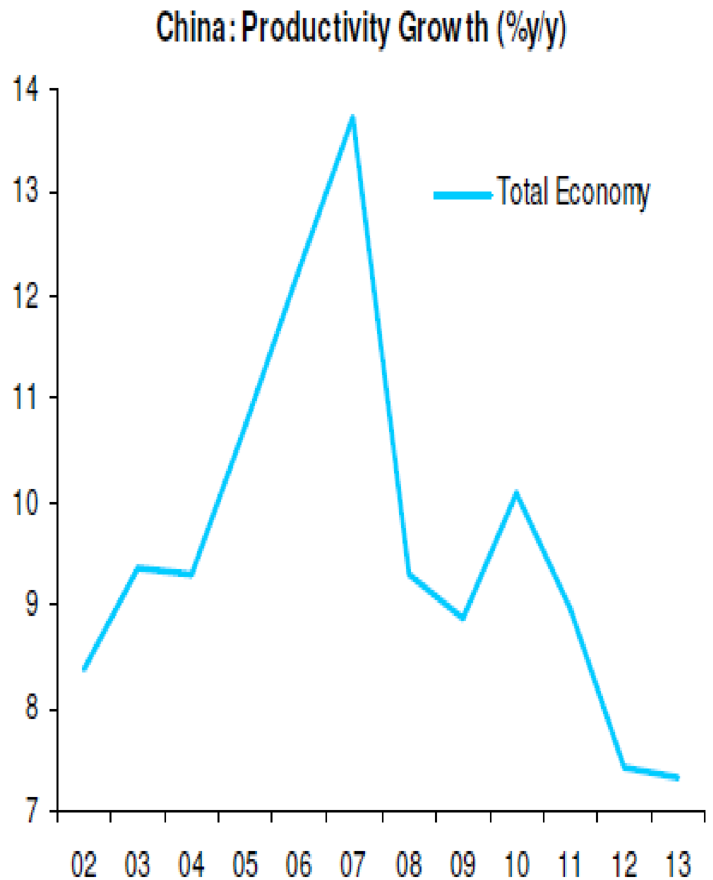
Particularly worrisome because China is also facing a slowdown in potential output

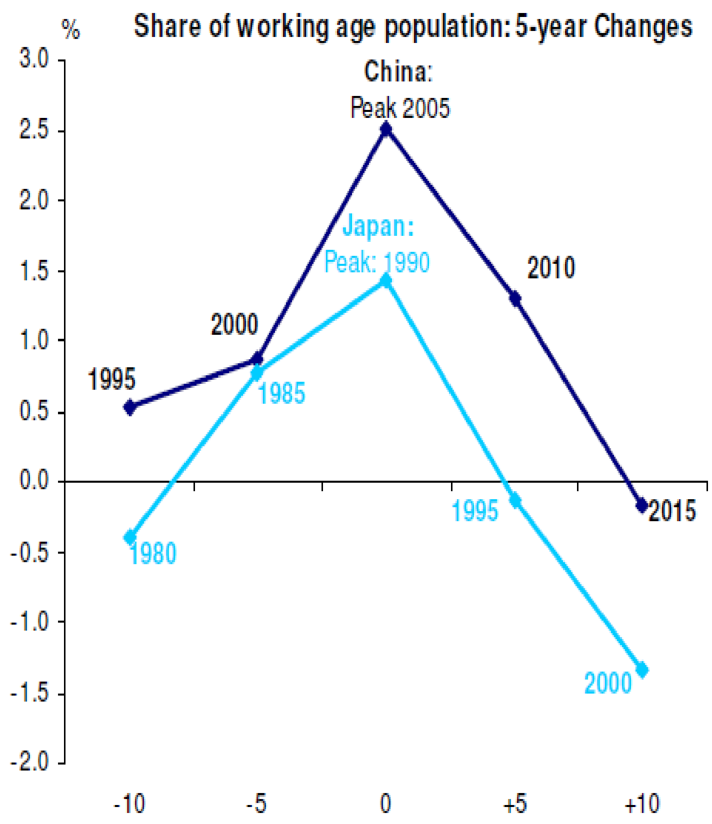
Slowdown in productivity growth

Figure 4.3.9



Demographic transition

Figure 4.3.10



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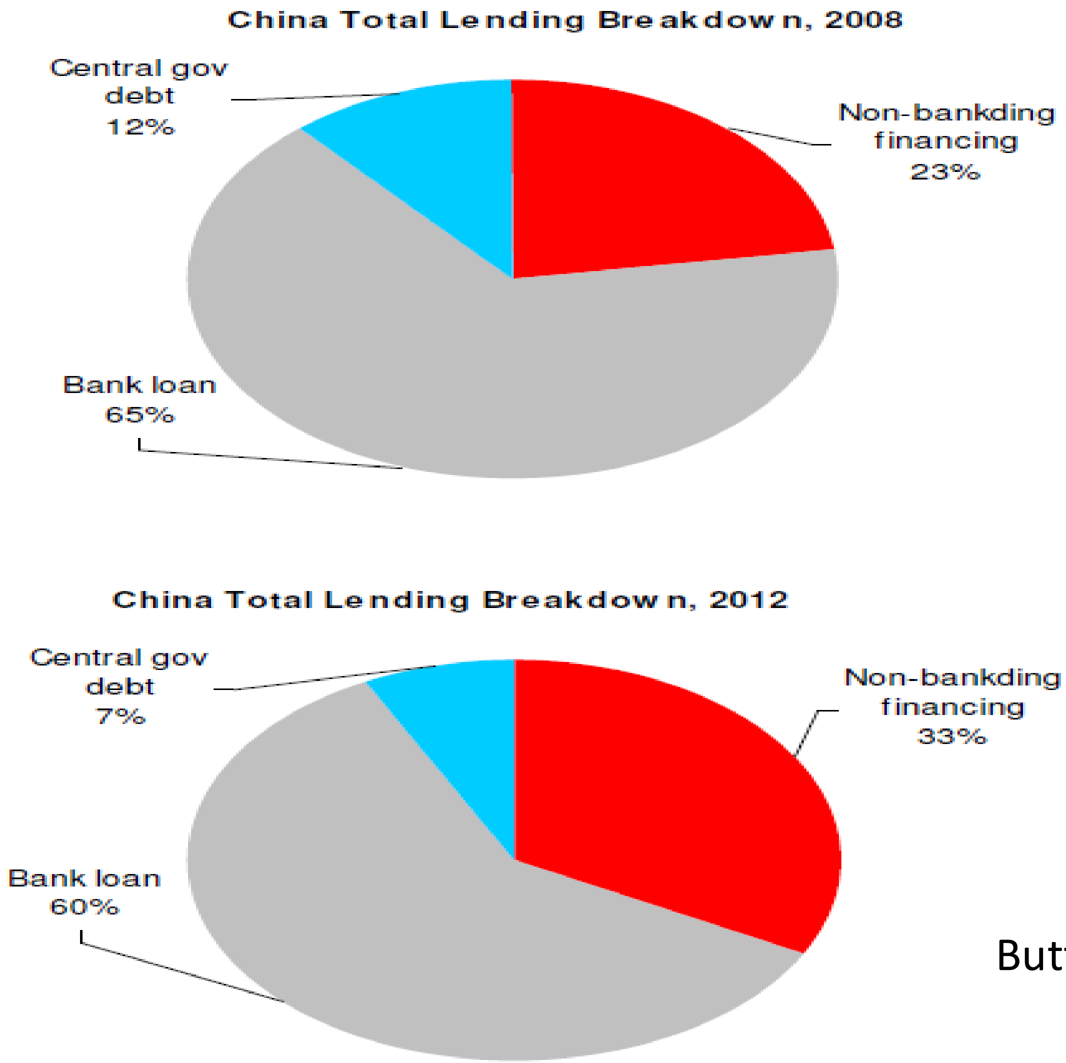
… and financial fragilities in need of reform

Figure 4.3.8



Weak lenders:

increasing importance of shadow banking

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Common challenges post crisis

- Decrease of potential output growth: “the stagnation hypothesis”

Which implies

… the natural rate of interest – the short-term real interest rate consistent with full employment – will be zero or negative

… low inflation, if not dealt with, will push real interest rates above the natural rate

Low growth, low inflation and high real interest rates will be a threat for debt sustainability

The secular stagnation hypothesis

- *Hansen 1938, after the great depression*

decline in the population birth rate and an oversupply of savings that was suppressing aggregate demand

- But then …
- ➢ Second World War led to a massive increase in government spending (ending any concern of insufficient demand)
- ➢ Post WWII baby boom

Larry Summers 2013

- The crisis of 2008 may have ushered in the beginning of secular stagnation
- This episode of low demand may even have started well before 2008 but was masked by the housing bubble before the onset of the crisis of 2008

Even the US pro-active support of aggregate demand is not enough …

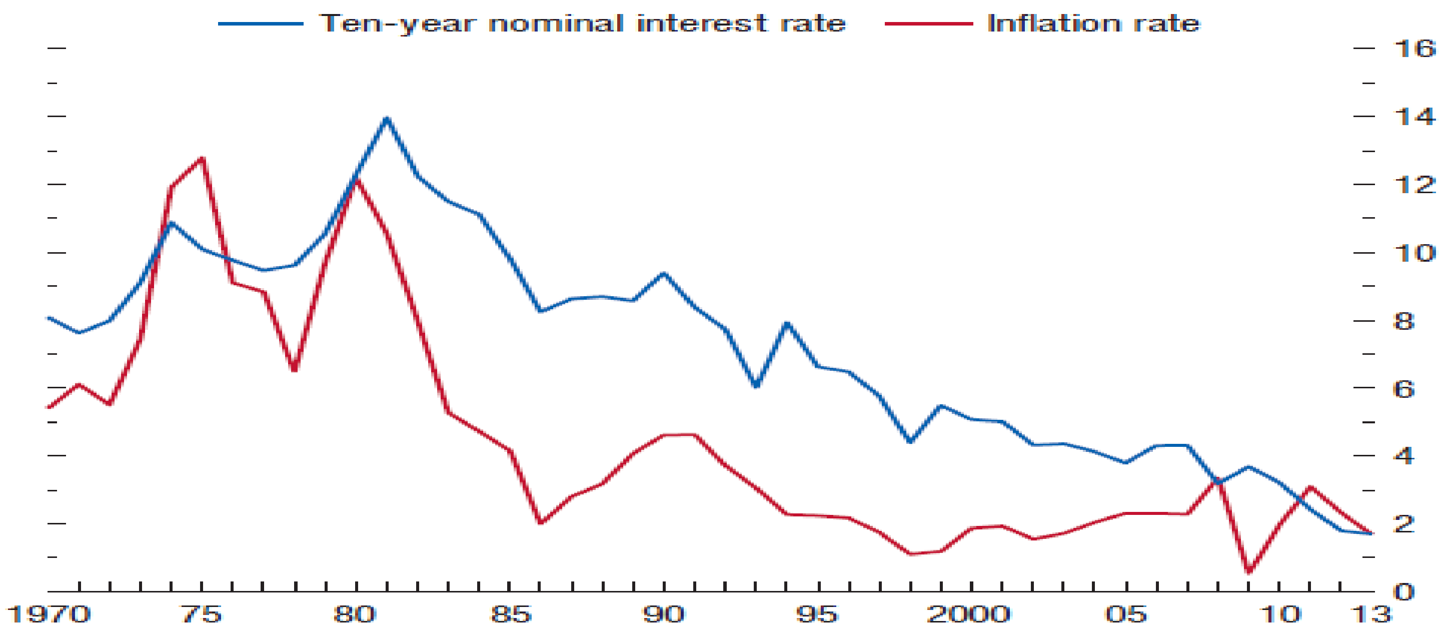
Implications for policy

- Boost aggregate demand via more fiscal expansion and protracted very low interest rate
- ➢ Emphasis on debt consolidation misplaced (the European view)
- ➢ Emphasis on risk of low interest rate environment leading to new bubbles misplaced (the BIS view). Monetary policy is not too loose – where is the inflation? The economy still has significant slack!
- ➢ Deal with bubbles via tight regulation policies targeted at investment

What will happen to interest rates?

Secular decline in interest rates and inflation
Will it continue?

Figure 3.1. Ten-Year Interest Rate on Government Bonds and Inflation
(Simple average across France, Germany, United Kingdom, and United States; percent a year)



Sources: Bloomberg, L.P.; Haver Analytics; Organization for Economic Cooperation and Development; World Bank, World Development Indicators database; and IMF staff calculations.
Note: Inflation is calculated as the percent changes in the consumer price index.

What will happen to interest rates?

Cyclical normalization and Fed exit suggest a rise

However:

- The stagnation hypothesis suggests a decline of the natural rate and therefore future very low nominal rate
- Debt risk may lead to increase in risk premia in some jurisdictions

So far global inflation and interest rates have been low ……

Where will they go in the future depends on what policy view will prevail …

Summing up

We may be in a recovery and in a new great moderation

But fundamental issues leading to secular stagnation imply that we are trapped between two alternatives: growing through bubbles which lead to new risk wave or the euro area model of stagnant growth

- Both scenarios carry risks
- Policy needs to be very creative to get us out of the trap!