



What happens next?

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What happens next?

“Never make forecasts, especially about the future.” Samuel Goldwyn.

But:

“Things that can't go on forever, don't” Herbert Stein

What happens next?

- Answer: nobody knows
- But we can ask where we are, how we got here and where we might go. I will do so.
- I will touch upon these six points:
 - Path to disaster
 - The crisis
 - “Green shoots”
 - Scenarios
 - State of the UK
 - Implications

What happens next?

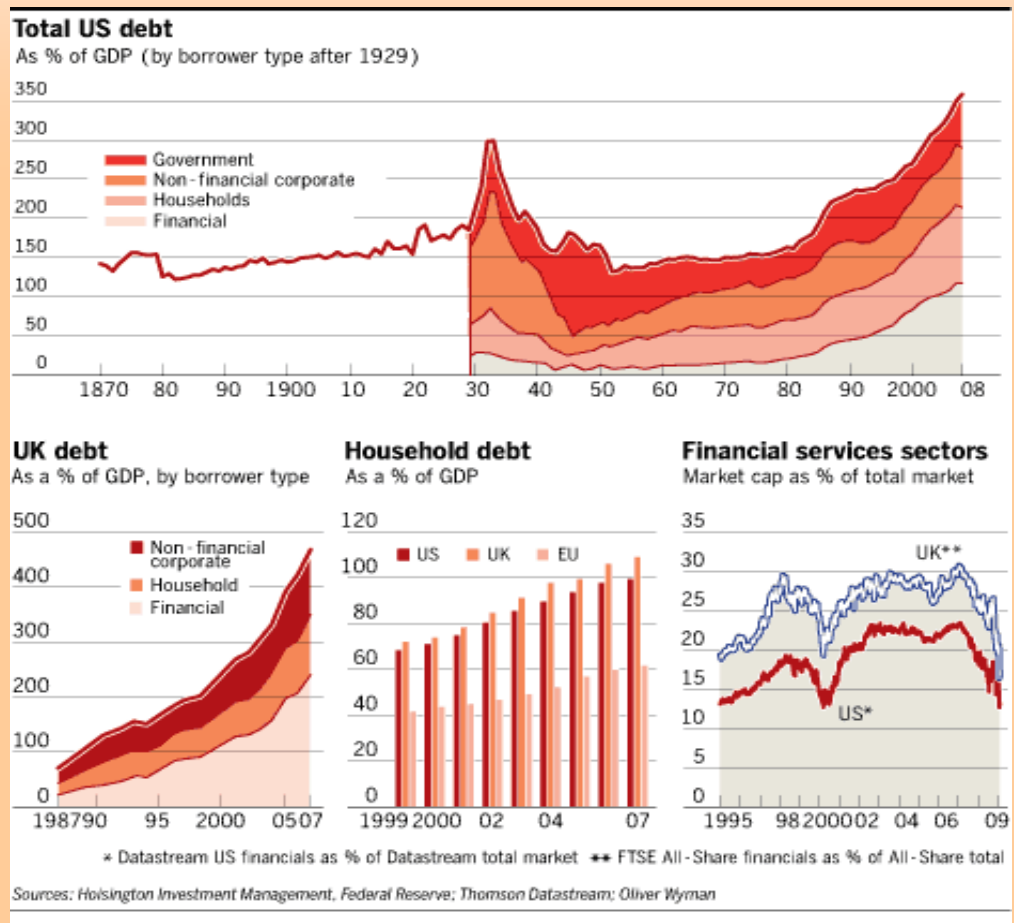
- The story so far:
 - Long build-up of imbalances and leverage;
 - Excessive risk-tolerance;
 - Then financial and economic crisis;
 - Unprecedented monetary and fiscal stimulus; and now
 - “Green shoots”, a decline in the rate of decline or, as Jean-Claude Trichet said, an “inflection point”
- So are we on the way to sustainable global recovery or to a relapse?
- And where does the UK fit into this global story?

1. Path to a disaster

- The late Hyman Minsky produced a canonical model of financial instability, based on a simple idea:
 - When times are good, investors take on risk
 - The longer the times stay good, the more risk they take on.
 - Ultimately, they take on too much risk, asset prices overshoot and then fall, debt is called in and asset values, credit and, at worst, financial institutions collapse
- Success breeds excess and excess breeds collapse

1. Path to a disaster

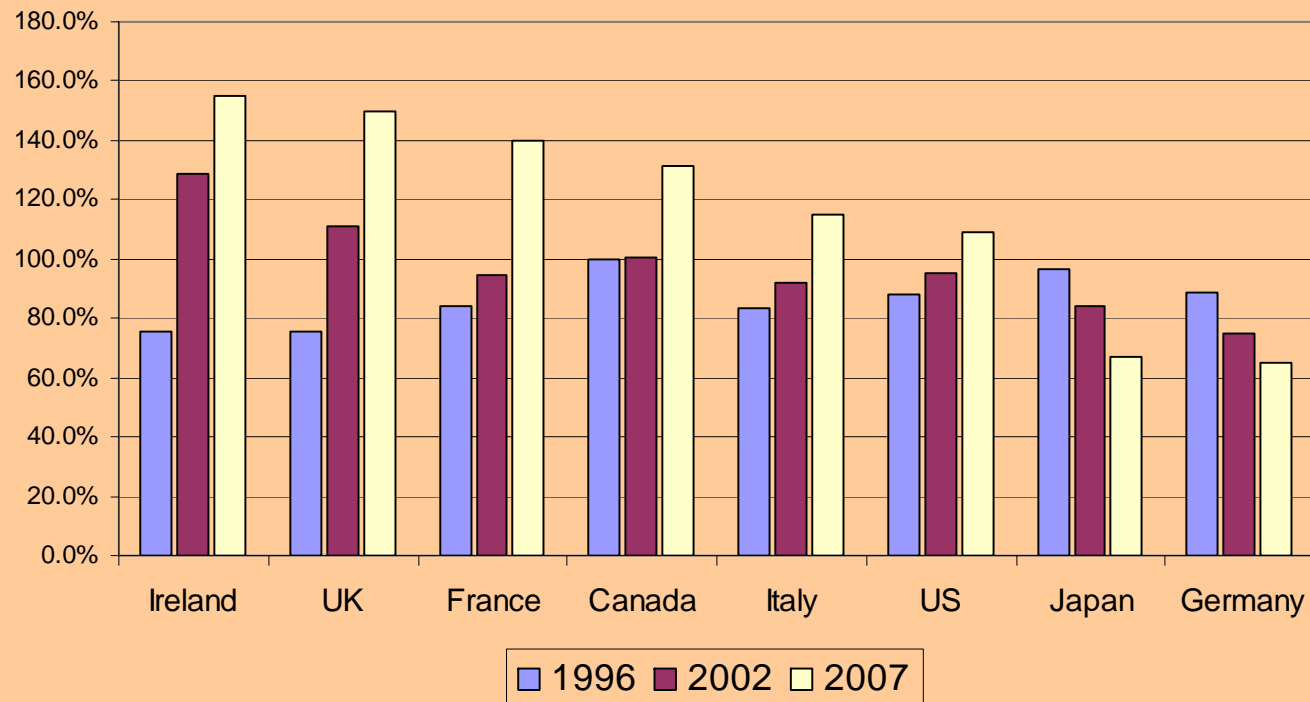
- The great credit boom hit the US hard.
- But it hit the UK even harder.
- Household debt reached unprecedented levels.



1. Path to a disaster – housing bubbles

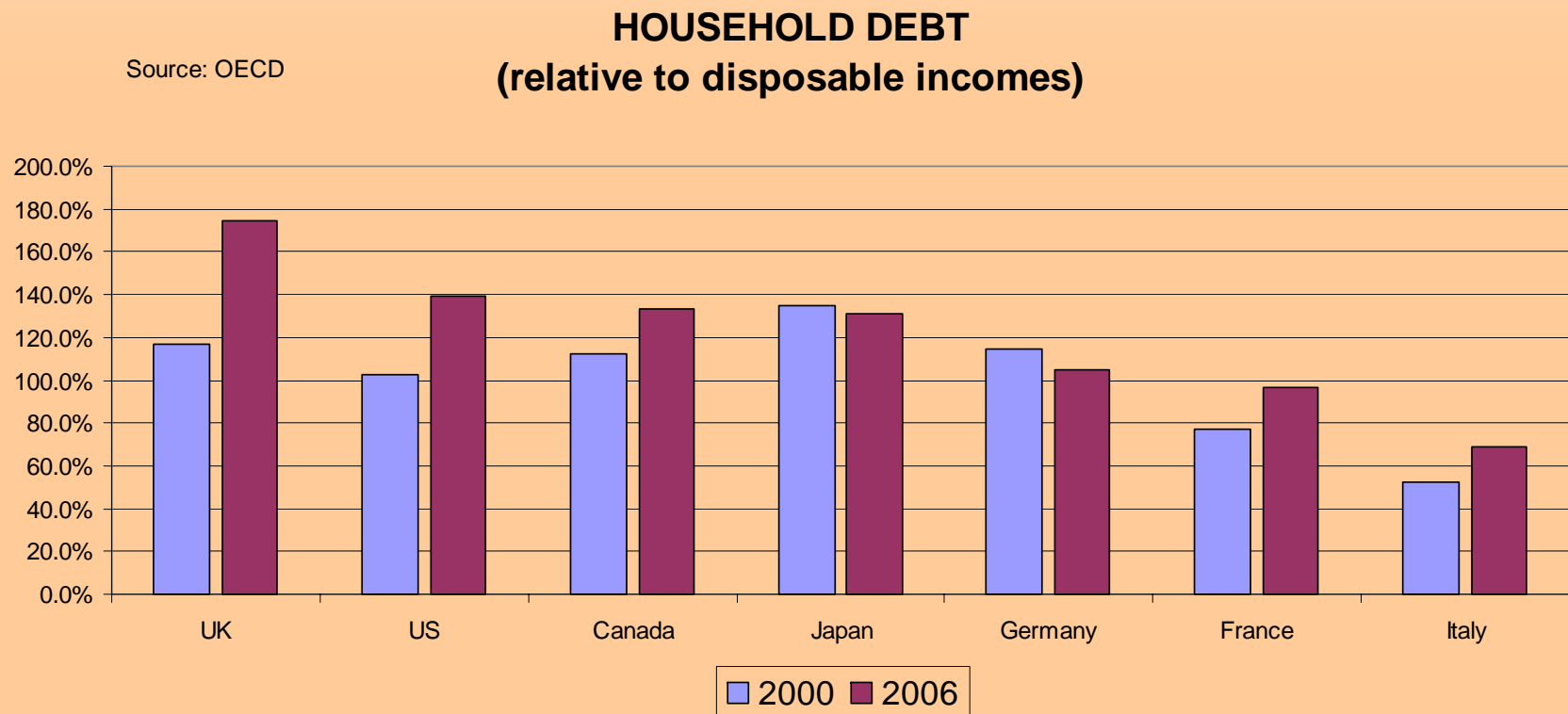
GREAT HOUSING BUBBLES

Source: OECD
HOUSE PRICES
(price-to-income ratio, long-term average = 100)



1. Path to a disaster – household debt

HOUSEHOLD BORROWING



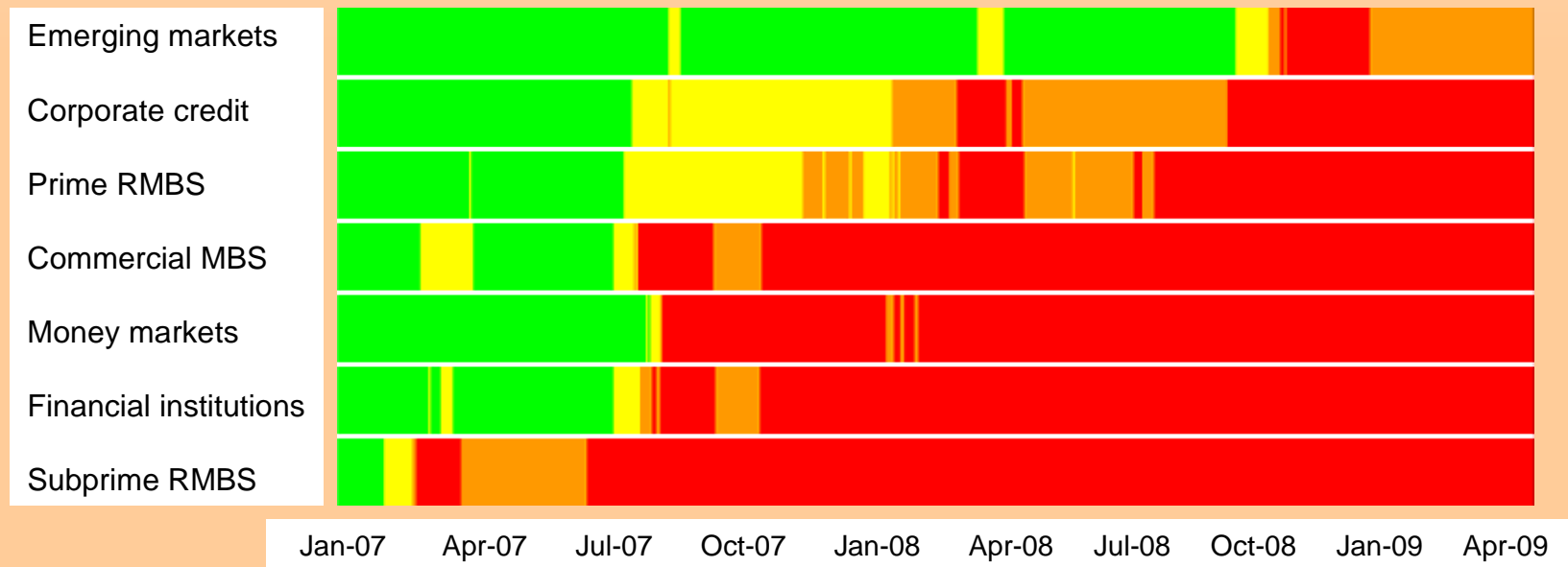
1. Path to a disaster – underlying forces

- So why did these huge global credit and housing bubbles occur?
 1. Emergence of huge global imbalances and extraordinary reserve accumulations in the late 1990s and early 2000s;
 2. Low real and nominal interest rates and the “reach for yield”;
 3. Accommodative monetary policy aimed at targeting inflation;
 4. Innovation in the financial sector, to provide notionally safe, high-yielding assets; and
 5. Relaxation of financial regulation

2. Crisis

RISK AVERSION SPREAD, AS BANKS DREW BACK

Figure 1.2. Heat Map: Developments in Systemic Asset Classes



Source: IMF staff estimates.

Note: The heat map measures both the level and 1-month volatility of the spreads, prices, and total returns of each asset class relative to the average during 2004-06 (i.e., wider spreads, lower prices and total returns, and higher volatility). The deviation is expressed in terms of standard deviations. Green signifies a standard deviation under 1, yellow 1-4 standard deviations, orange 4-7, and red greater than 7. MBS = mortgage-backed security; RMBS = residential mortgage-backed security.

2. Crisis

- Actions of G7 governments in October 2008 saved core banking institutions
- Confidence is returning
- But recessionary forces are powerful:
 - IMF estimates financial sector write-downs at \$4.1 trillion
 - Asset price falls are continuing; and
 - Consumers have cut back spending, with a chance of further rises in savings in big indebted countries

2. Crisis

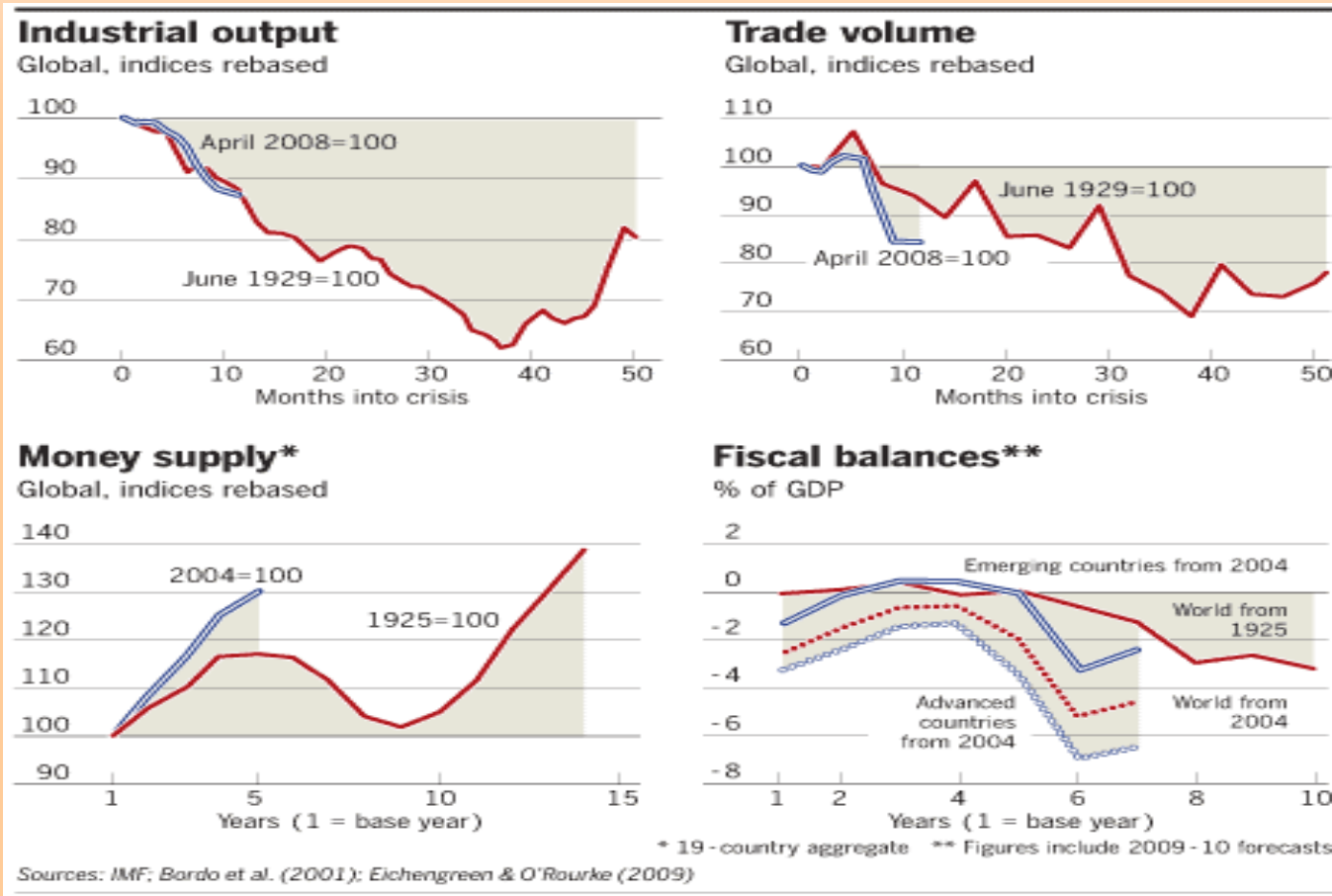
PUBLIC SUPPORT FOR BANK WHOLESALF FUNDING

		Wholesale Funding in 2008 Q2	Central Bank Liquidity (Crisis Balance Sheet Growth)	Government Asset Purchases Commitment	Government Guarantee Commitment
US	Money Market	\$1,908	\$980	\$1,850	\$1,830
	Longer Term	\$2,908			
Eurozone	Money Market	\$12,015	\$820	\$225	\$1,400
	Longer Term	\$8,877			
UK	Money Market	\$3,869	\$150	\$450	\$1,250
	Longer Term	\$1,349			
Total		\$30,926	\$1,950	\$2,525	\$4,480

Source: Global Financial Stability Report, April 2009

2. Crisis

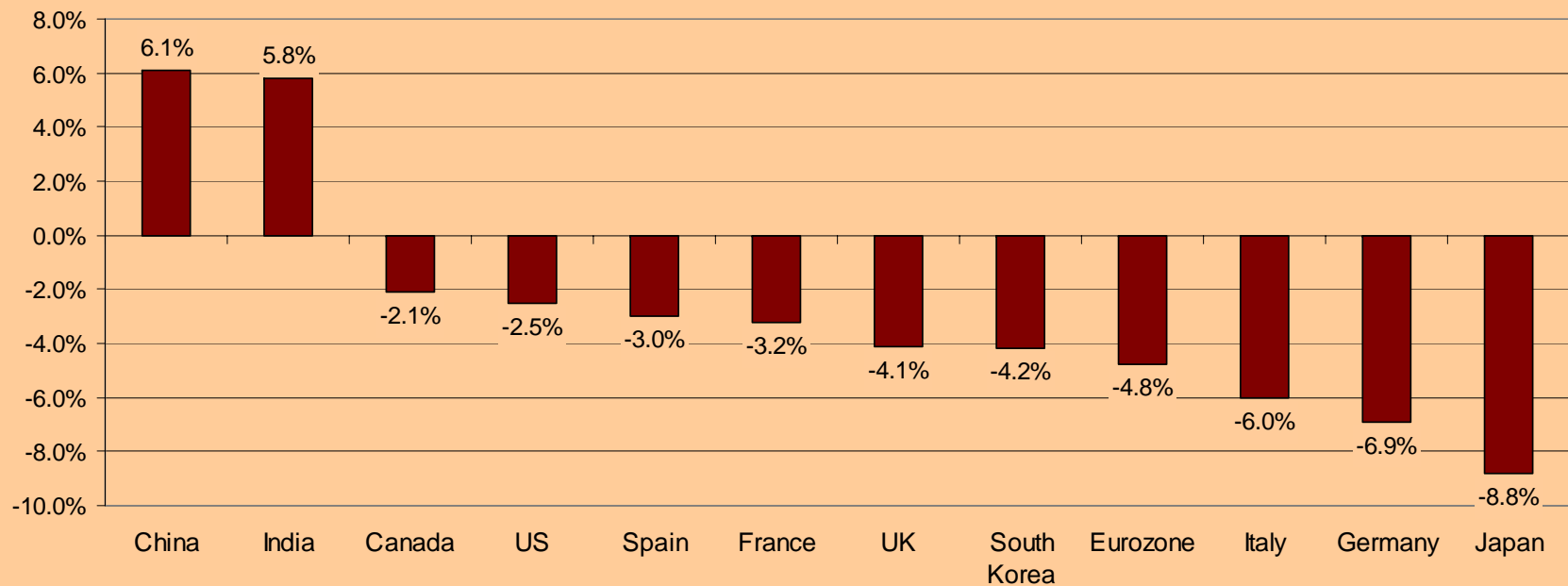
COMPARISONS WITH THE GREAT DEPRESSION



2. Crisis

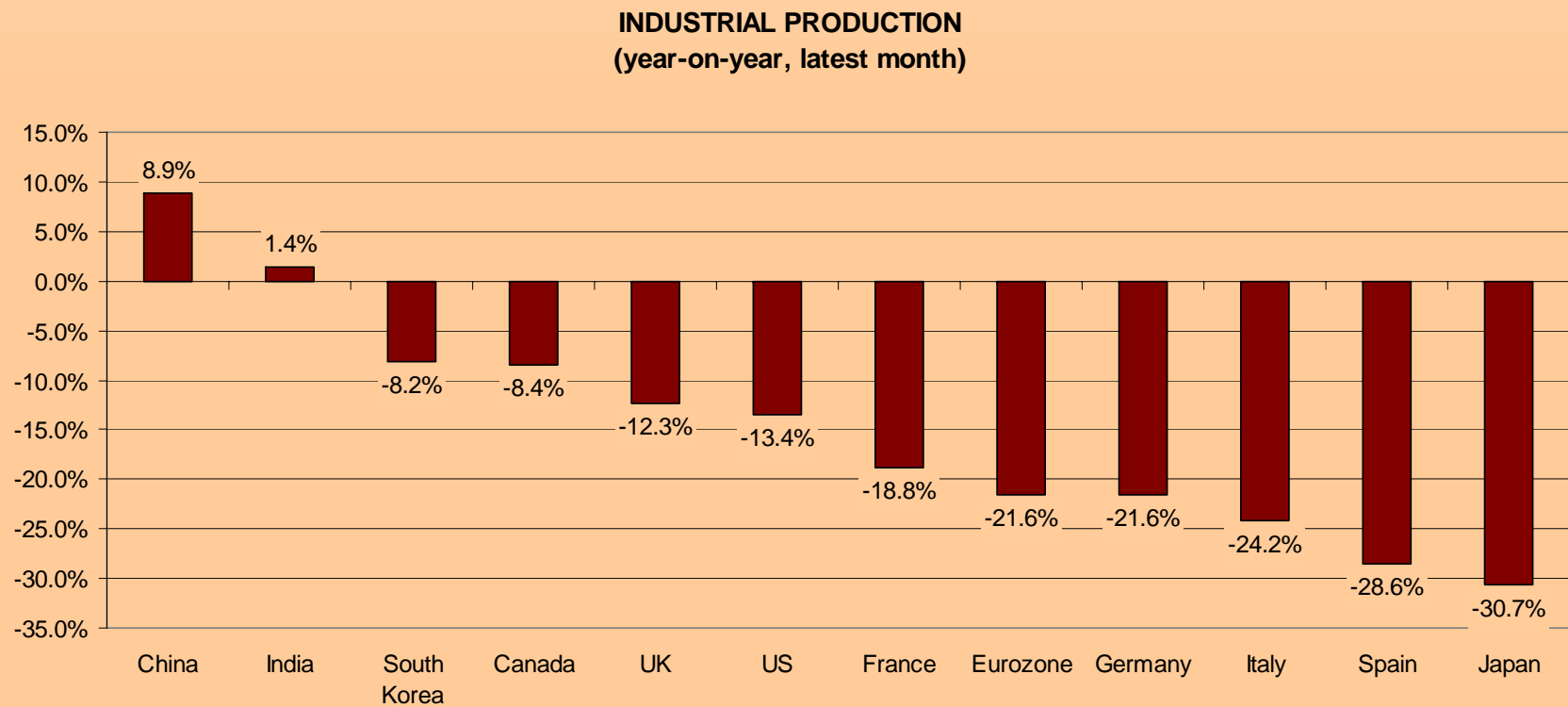
UK IS LESS AFFECTED BY ECONOMIC COLLAPSE

GROWTH TO FIRST QUARTER 2009
(year-on-year, per cent)



2. Crisis

OR BY INDUSTRIAL COLLAPSE

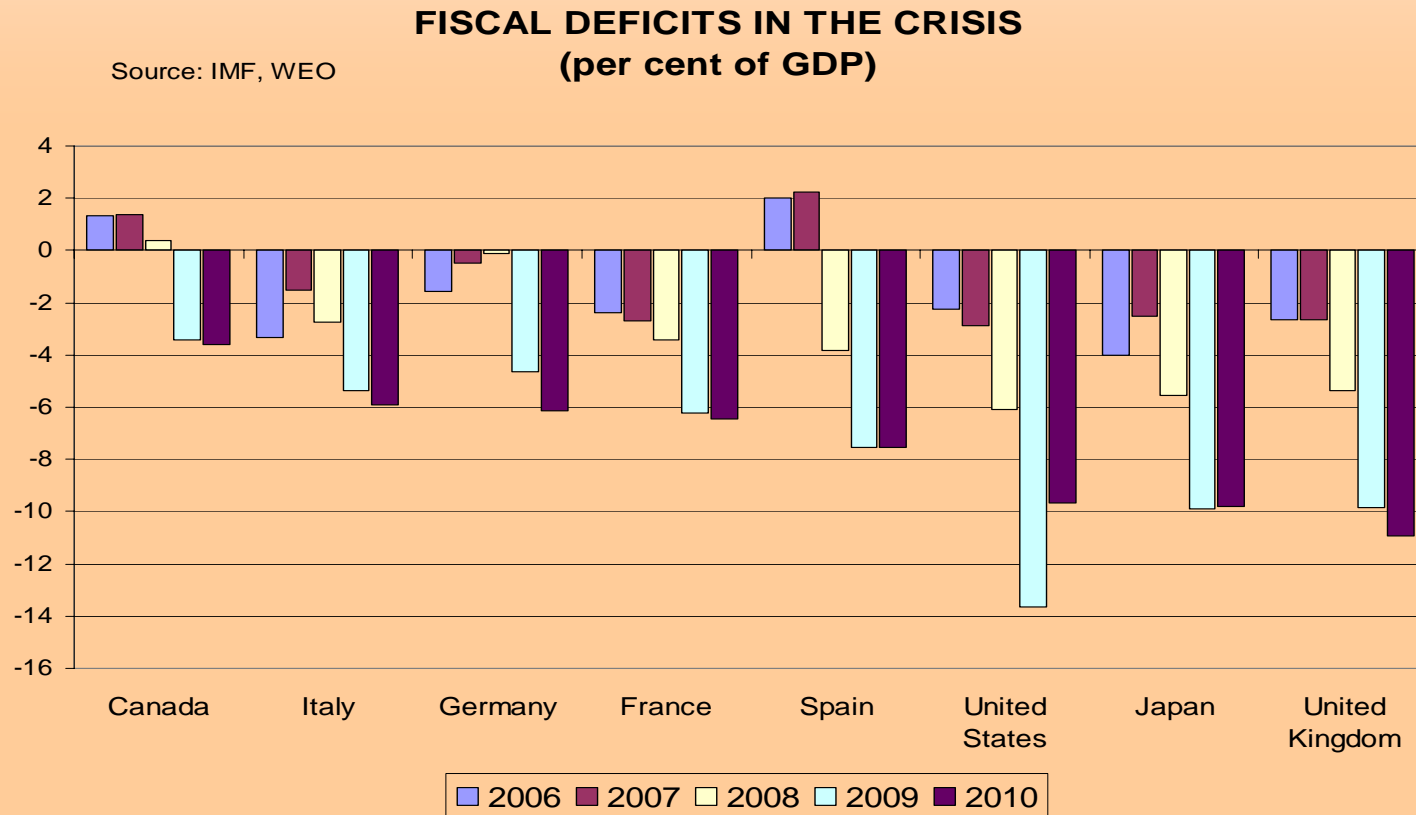


3. Green shoots

- Stimulus applied has been massive, both fiscal and monetary;
- The biggest fiscal stimulus is in the countries with external deficits;
- Rate of economic decline has slowed; and
- Forward-looking signs of recovery have emerged

3. Green shoots

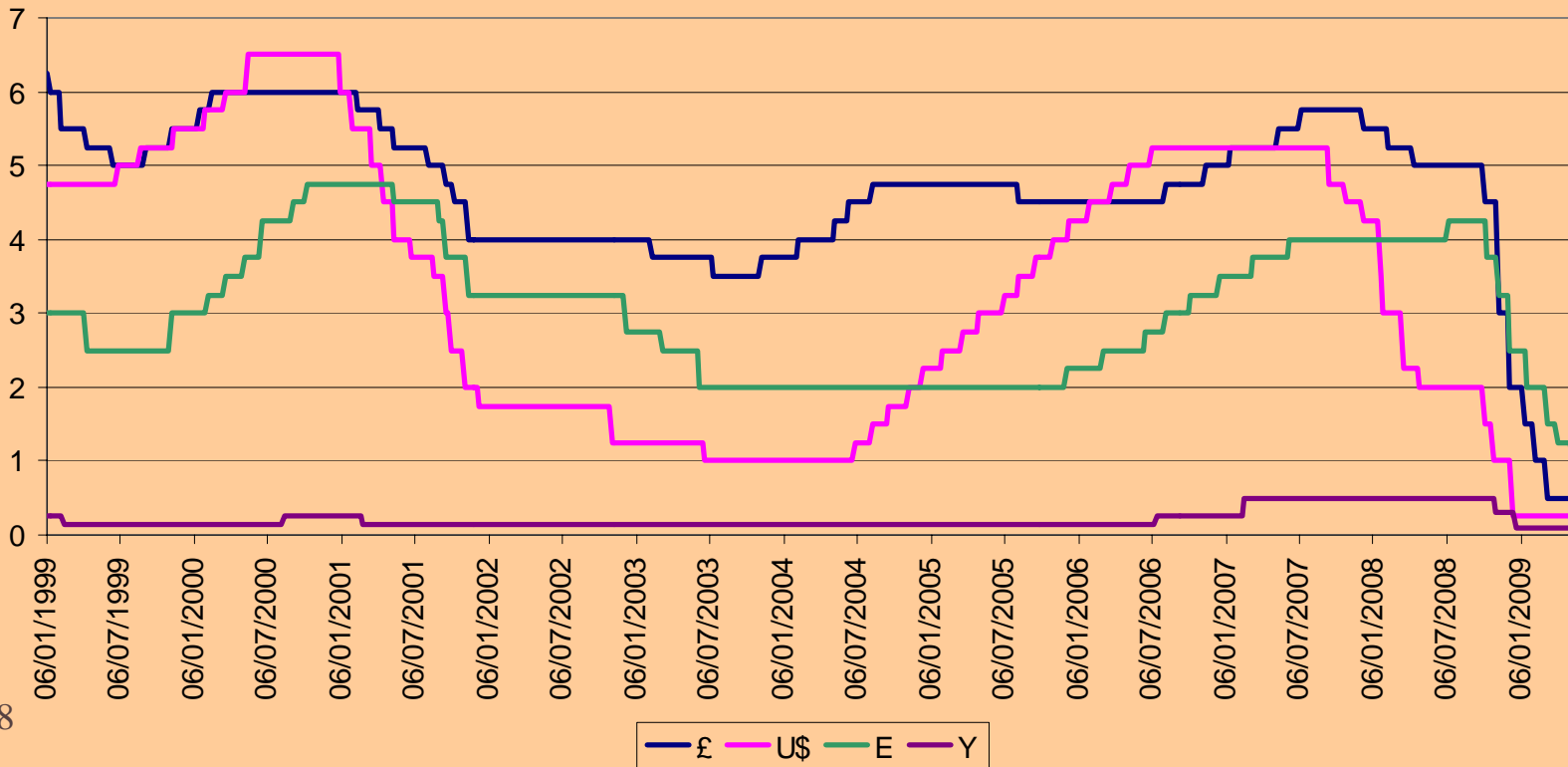
FISCAL STIMULUS IS MASSIVE



3. Green shoots

SO IS MONETARY STIMULUS

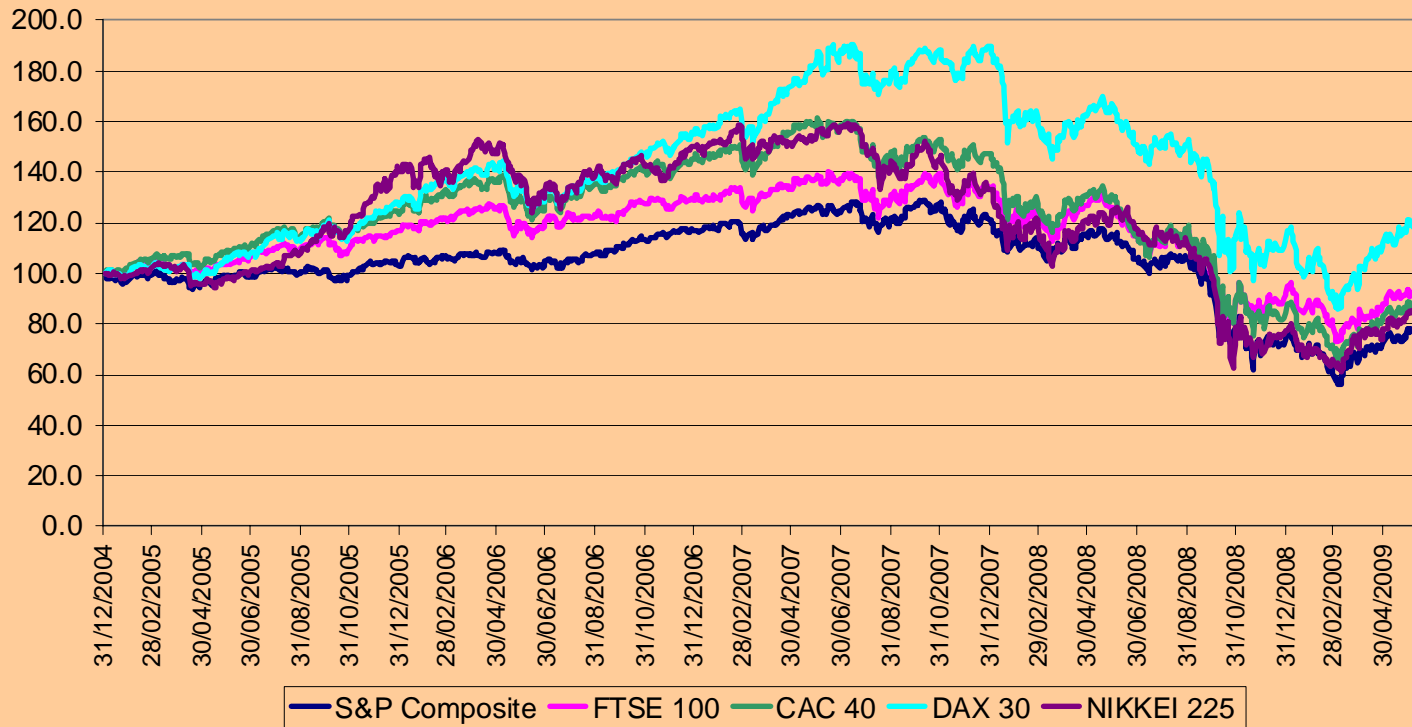
**CENTRAL BANK INTERVENTION RATES
(per cent)**



3. “Green shoots”

STOCK MARKET BOUNCE

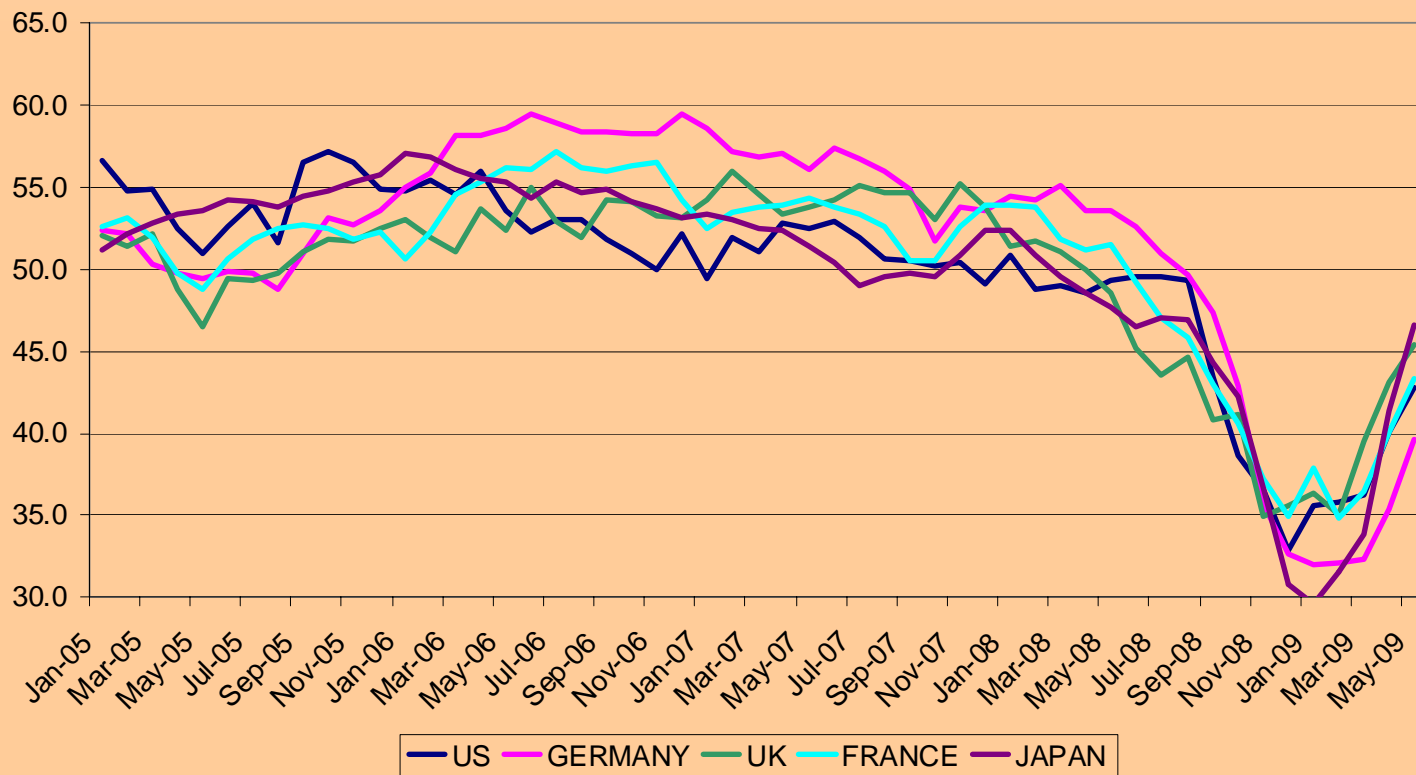
STOCK MARKETS
(local currency)



3. “Green shoots”

BUT CONFIDENCE BEGINS TO RETURN

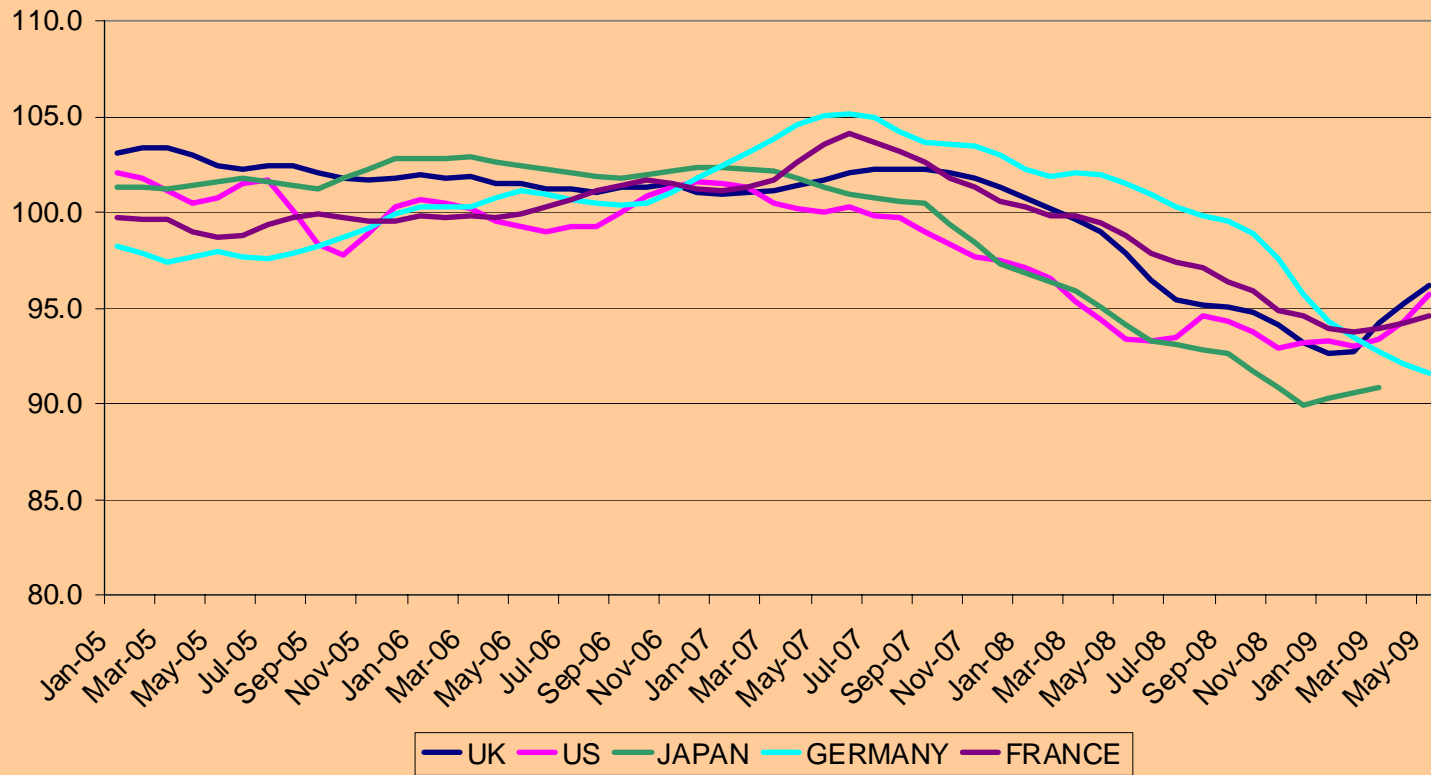
PURCHASING MANAGERS' INDICES MANUFACTURING



3. “Green shoots”

BUT CONFIDENCE BEGINS TO RETURN

CONSUMER CONFIDENCE

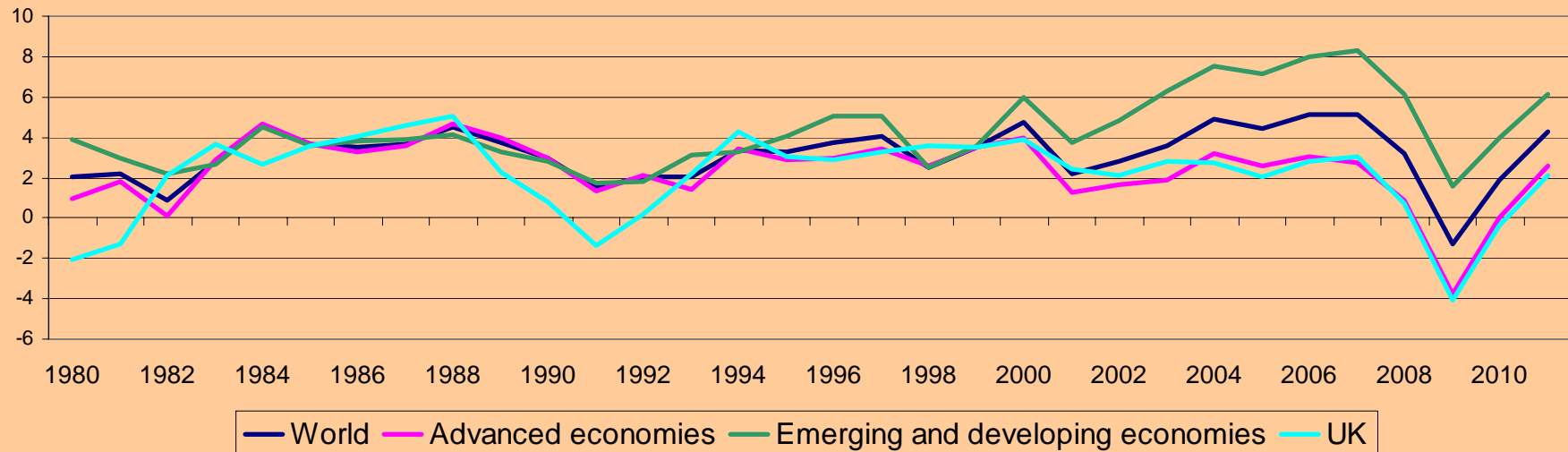


4. Scenarios

THE FUTURE – BUT IS IT GRIM ENOUGH?

WORLD ECONOMIC GROWTH (at purchasing power parity)

Source: IMF WEO April 2009



4. Scenarios

- Scenario 1: Swift recovery:
 - Massive stimulus delivers quick restoration of demand in the big deficit countries and return to business as usual;
 - But big further increases in private debt
 - Little rebalancing of the world economy
 - and so increased vulnerability for the future
 - Also risk of oil price spike
- This would be a V-shaped recession, but with real danger of a relapse some years in the future
- What worries me is that this would be unsustainable

4. Scenarios

- Scenario 2: Muddling through:
 - Modest pick-up of private spending; and
 - Weak recovery in US followed by other deficit high-income countries in 2011, which would pull export-oriented economies
- This would be an extended “U-shaped” recession
- This seems a likely outcome.
- But it would also leave huge challenges of de-leveraging and re-balancing ahead

4. Scenarios

- Scenario 3: Full adjustment
 - Strong pick up of demand in surplus countries
 - Export- and investment-led growth in deficit countries
 - De-leveraging in deficit countries, as well
- This also would be an extended “U-shaped” recession
- This seems an unlikely outcome.
- But it would leave more stable growth in the years ahead

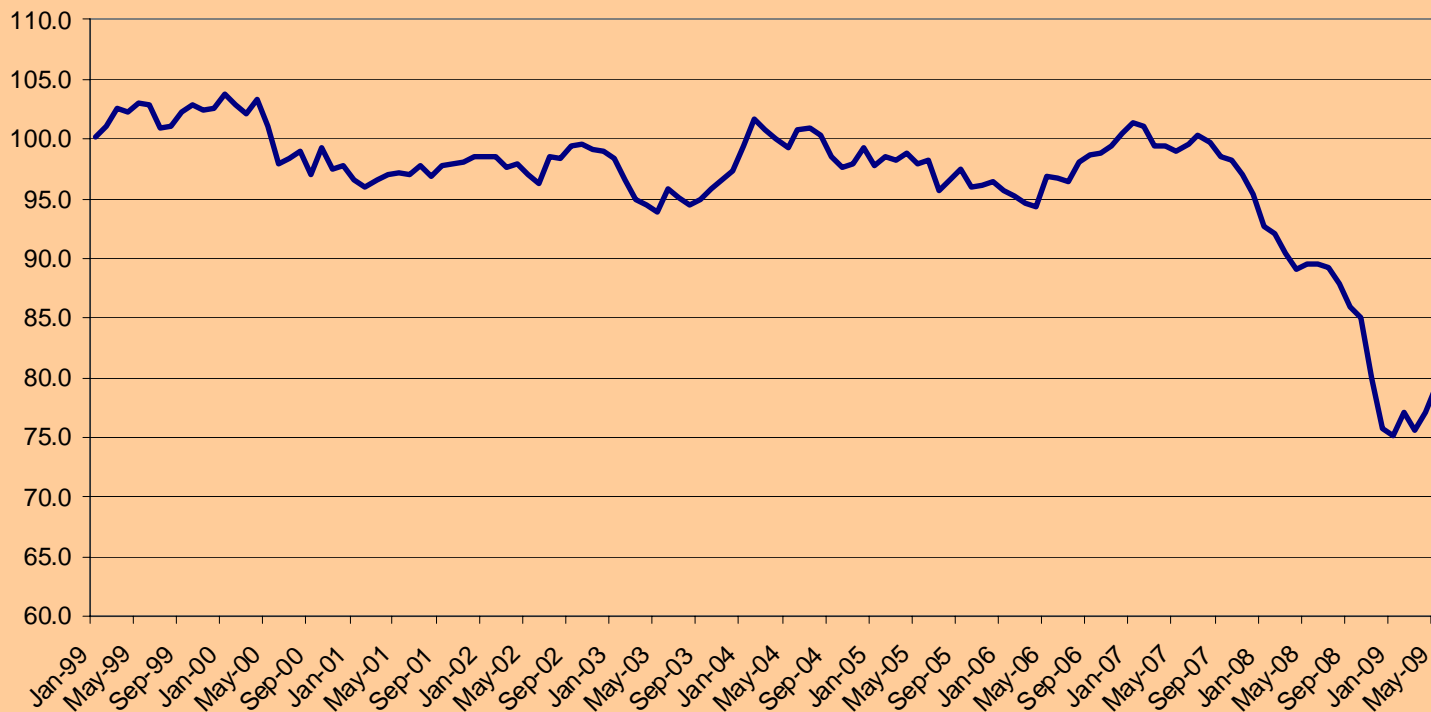
5. State of the UK

- The UK has an open economy and is, in consequence, very vulnerable to global developments
- It has had the benefit of a big depreciation of the external value of sterling, but this will bring benefits only when the world economy recovers
- The UK is less vulnerable to declines in manufacturing than most other advanced economies

5. State of the UK

UK REAL EXCHANGE RATE

Source: JP Morgan



5. State of the UK

- But it has three particular vulnerabilities:
 - To the financial sector, epicentre of the crisis;
 - To a big housing bubble; and
 - To high levels of household indebtedness.
- Even though it directly generates only 8 per cent of GDP, the financial sector plays a large role in the economy, as a source of demand for other activities (legal, consulting and other services), taxes and foreign exchange
- The housing sector is big determinant of household wealth
- High indebtedness makes it more likely that falling house prices will generate negative equity

5. State of the UK

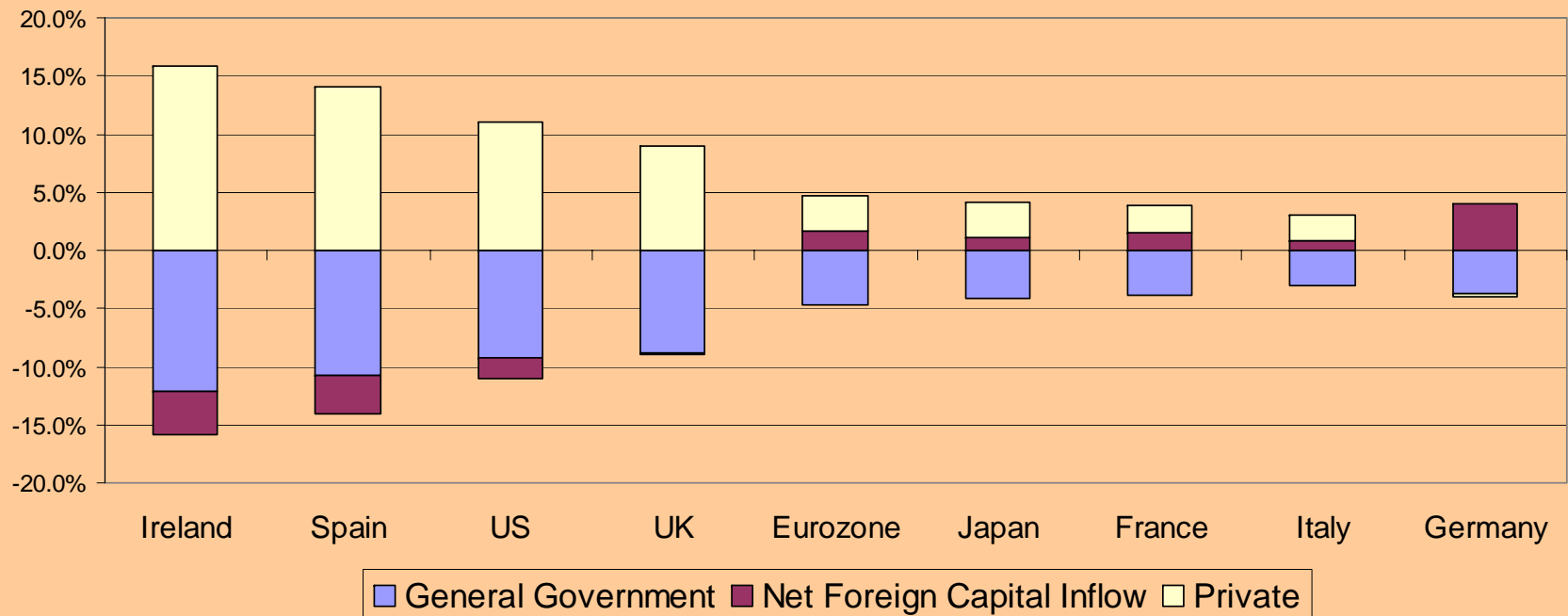
- Because of the interaction of these three factors, the UK has suffered substantial losses in tax revenue
- In addition, public spending has exploded, relative to GDP
- This creates a big dilemma for policy: the government needs to spend heavily, to offset the weakening of domestic demand, but it is unclear how long the government can sustain current spending

5. State of the UK

UK PRIVATE SECTOR SHIFTS TO HIGHER SAVING

SHIFT IN SECTORAL BALANCES, 2007-09

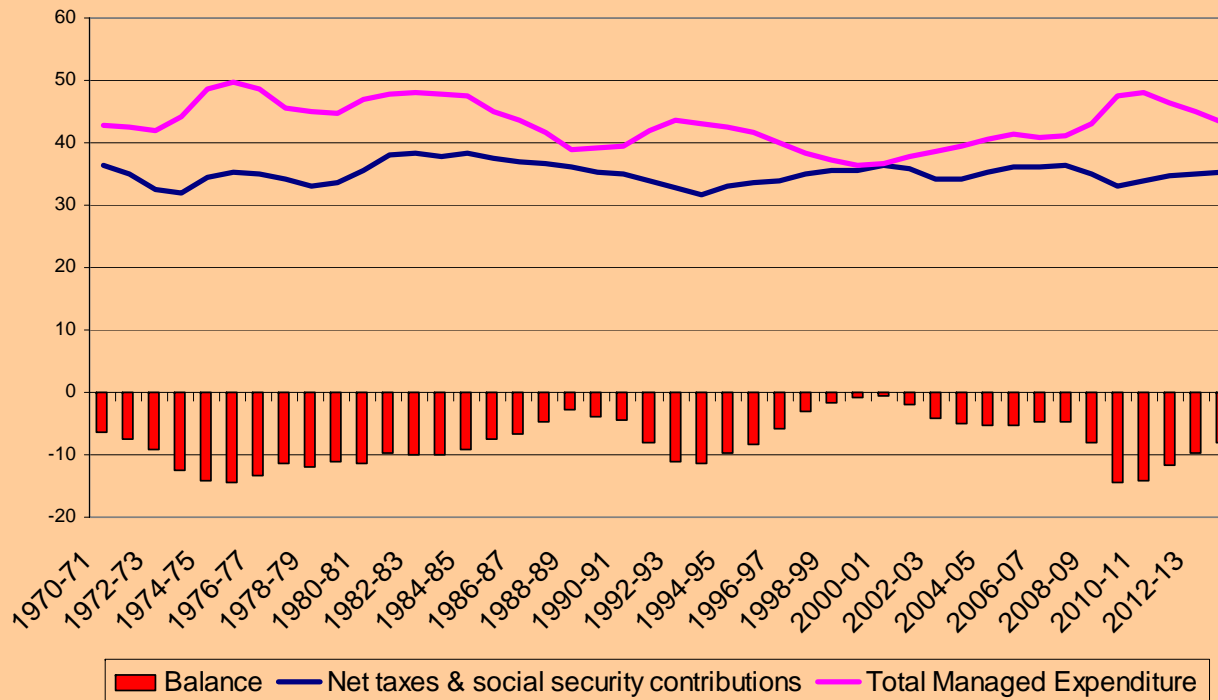
Source: EU Commission



5. State of the UK

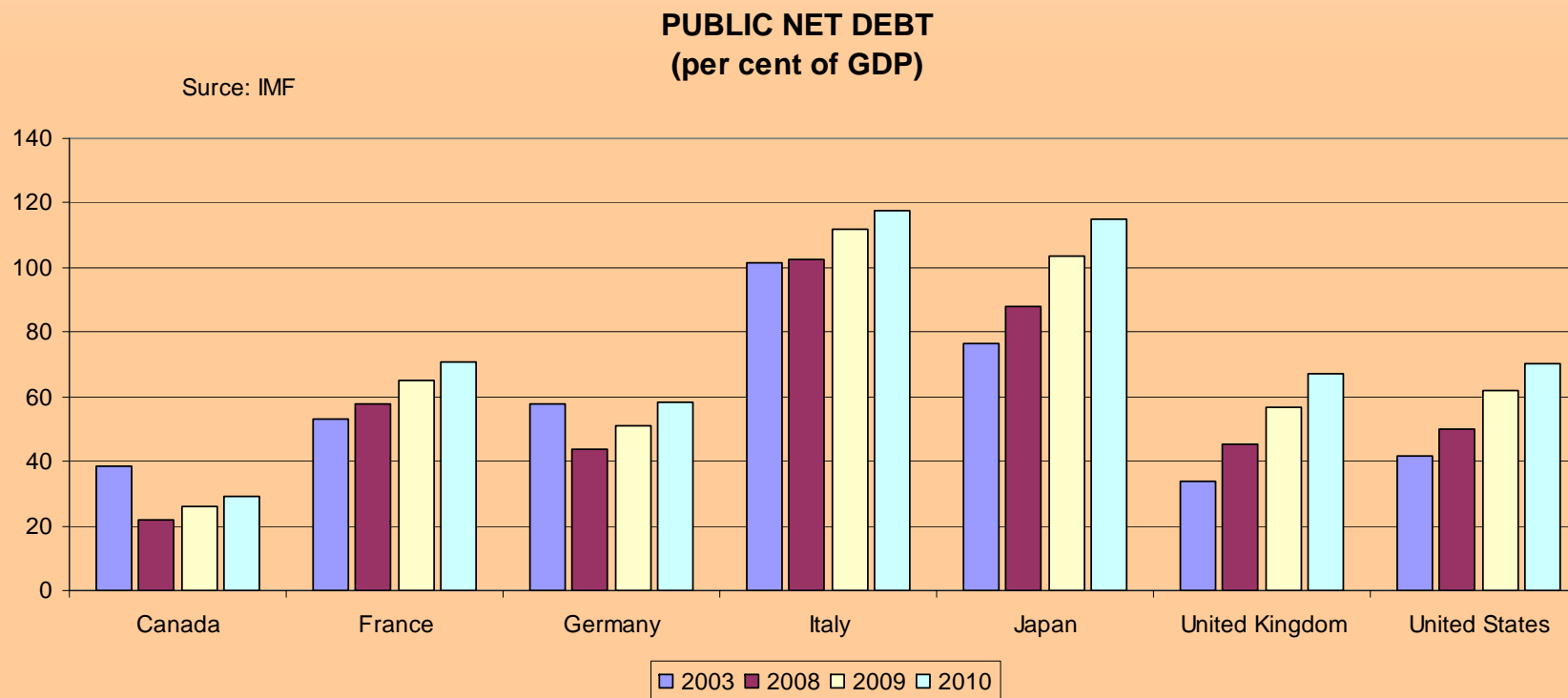
UK FISCAL DEFICITS EXPLODE

**PUBLIC SPENDING AND REVENUE IN THE UK
(per cent of GDP)**



5. State of the UK

AND PUBLIC DEBT SOARS



6. Implications

- The big questions about the world economy are:
 - First, how long can governments maintain stimulus, before risk-aversion spreads to its debt and panic about inflation grows?
 - Second, will it be possible to reignite private sector credit booms?
 - Third, can this be done without generating further bubbles?
 - Fourth, if the above is impossible, will we have a better balance of demand and supply across the globe and, if so, how?
 - Fifth, if growth restarts what happens to oil prices and inflation?

6. Implications

- The big questions about the UK economy are:
 - First, how long can policymakers maintain stimulus, before risk-aversion spreads to its debt and panic about inflation grows?
 - Second, what is going to happen to the financial sector?
 - Third, what is going to happen to the housing market?
 - Finally, what is going to happen to household borrowing?
- I would stress three big points:
 - The extraordinary uncertainty of the global economic environment;
 - The high possibility that recovery will prove very bumpy; and
 - The risk that further crises will befall us not far down the road

6. Implications

- Implications for human resource management:
 - Big structural changes in the economy are certain;
 - Unemployment is likely to be high for a long period;
 - The role of the public sector as a source of additional employment is over – it will be shrinking;
 - Public spending is going to be drastically cut;
 - Public spending on investment will be halved in real terms;
 - Labour market friction seems highly likely; and
 - Public sector labour market friction seems certain