The Global financial crisis: When will there be light at end of tunnel?”

Kenneth Rogoff, Harvard University

The Nordic Globalization Forum

Blue Lagoon, Iceland February 2009

Spot on: European leaders including Angela Merkel, Nicolas Sarkozy and Gordon Brown take their places at a photocall after their meeting in Berlin yesterday Getty

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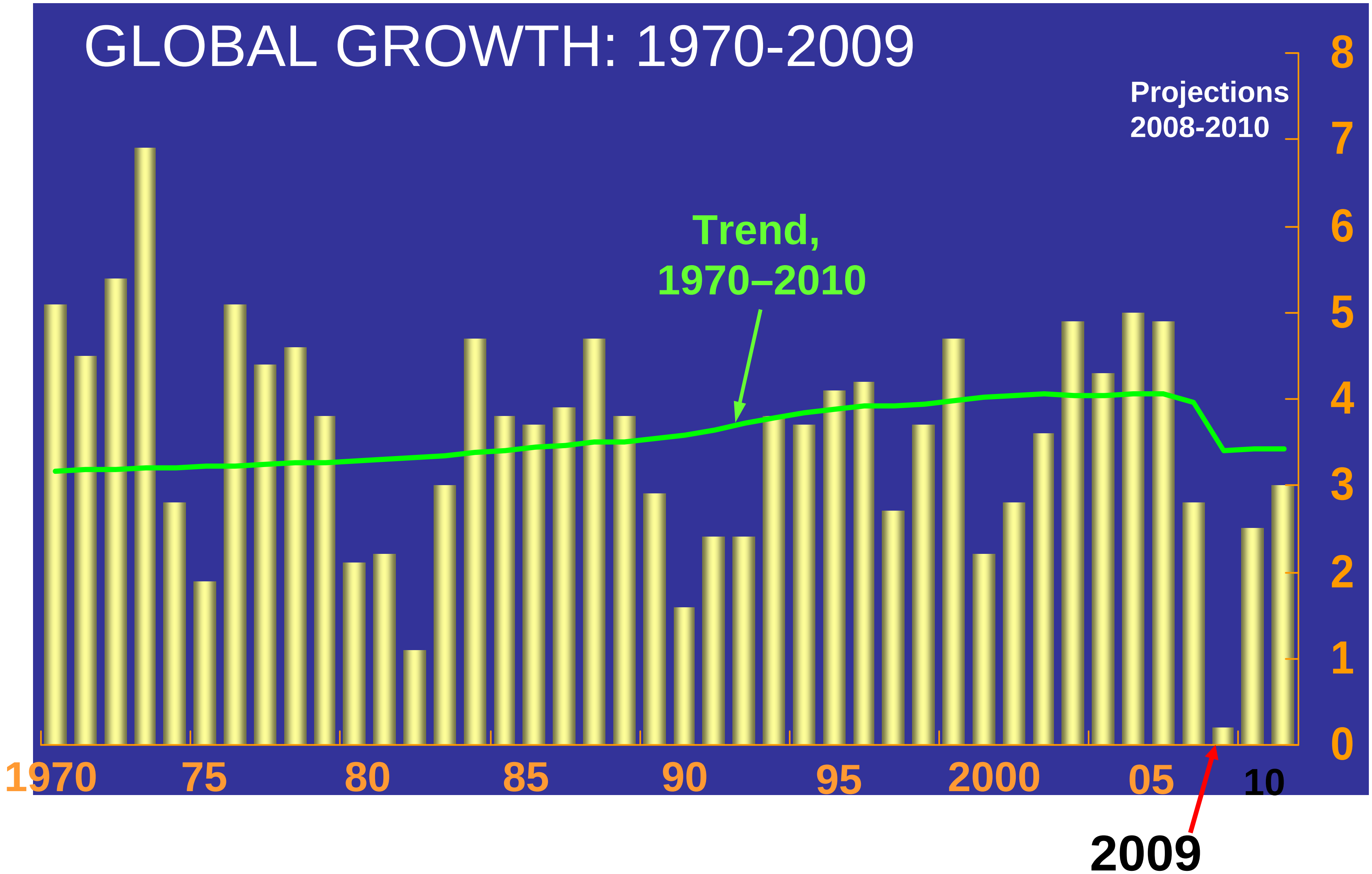
European Leaders Search for a Bottom to the Recession

Kenneth Rogoff, Harvard

Global Recession: Worst since 30s?

(Real Global GDP; annual percent change)



Kenneth Rogoff, Harvard

- Europe, Japan, US in deep recession
- China extremely vulnerable
- Emerging markets suffering from low commodity prices, sudden credit stop
- BUT even recessions associated with financial crises do end.
- Few recessions last more two years

How did we get here?

- Biggest culprit: Hubris. This time is different because of
  - Financial globalization
  - New technologies
  - Superior policymakers and institutions
- Global imbalances, especially US borrowing and Asian surpluses, fueled an unsustainable housing boom
  - Mistakes in deregulation arguably grew out illusion of prosperity created by debt.

In US, all red lights were blinking

- Every evidence there would be a massive financial crisis: massive current account and trade balance deficits, huge asset price inflation, rising leverage.
- But cheerleaders like US Treasury Secretaries and Federal Reserve Chairman were in denial despite credible warnings from economists.
- Fed role should be to warn and protect against risks, not just to make the best “market calls”

A myth that advanced economies have less problems with financial crises

Little Difference in the Frequency of Banking Crises in Advanced and Emerging Economies

	Advanced Economies % years	Emerging Economies % years
Since 1800 or Independence	**7.2**	**8.3**
Since 1945 or independence	**7.0**	**10.8**

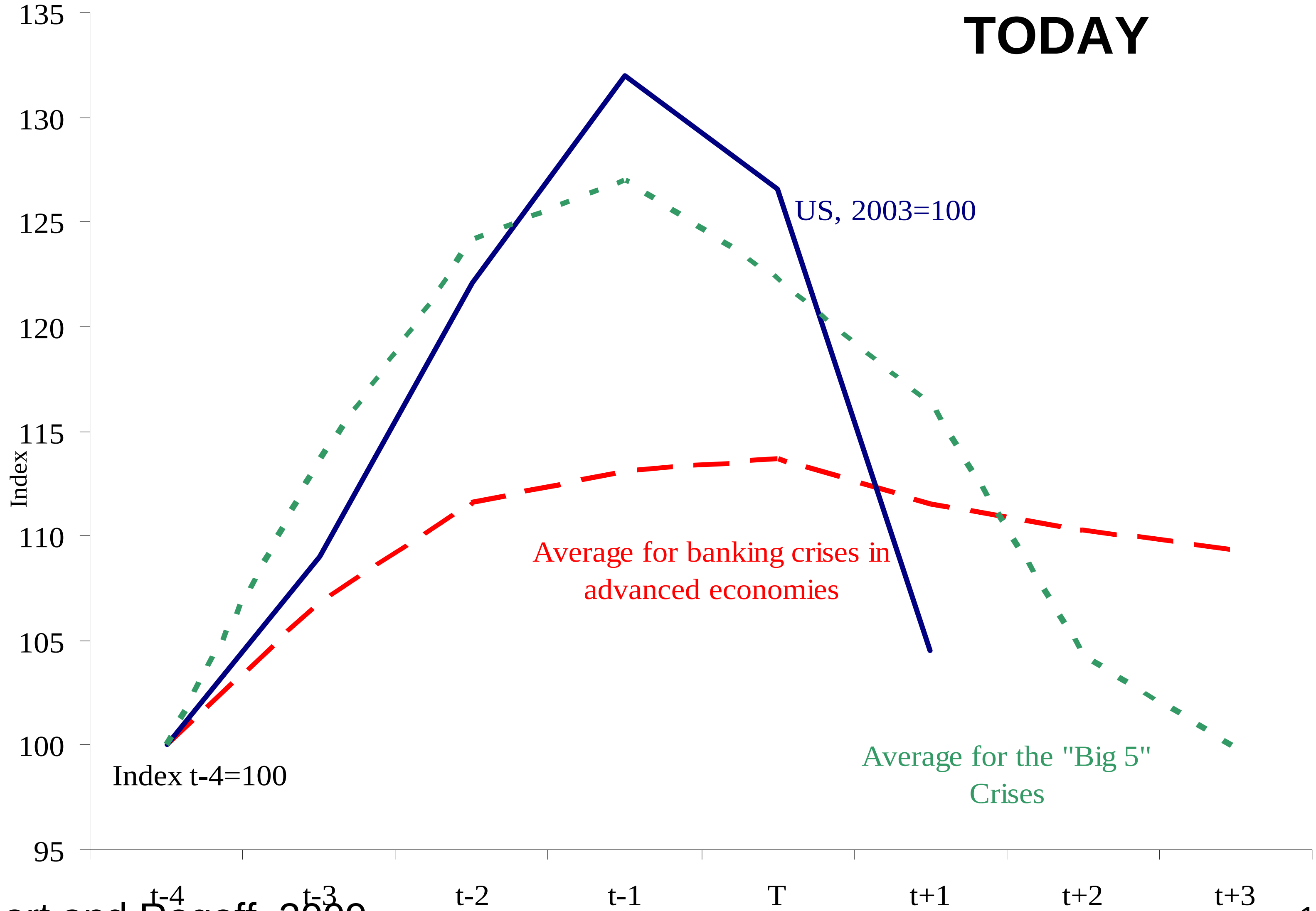
Reinhart and Rogoff, 200,
"Banking Crises: An Equal Opportunity Menace"

A comparison of trajectory of US Recession with past financial crises

- 18 major financial crises in developed countries since World War II
- Worst 5 (“big five”) are Spain (1977), Norway (1987), Finland (1991), Sweden (1992), Japan (1992)

- **Quantitatively, the US is driving down the tracks of a typical deep financial crisis**

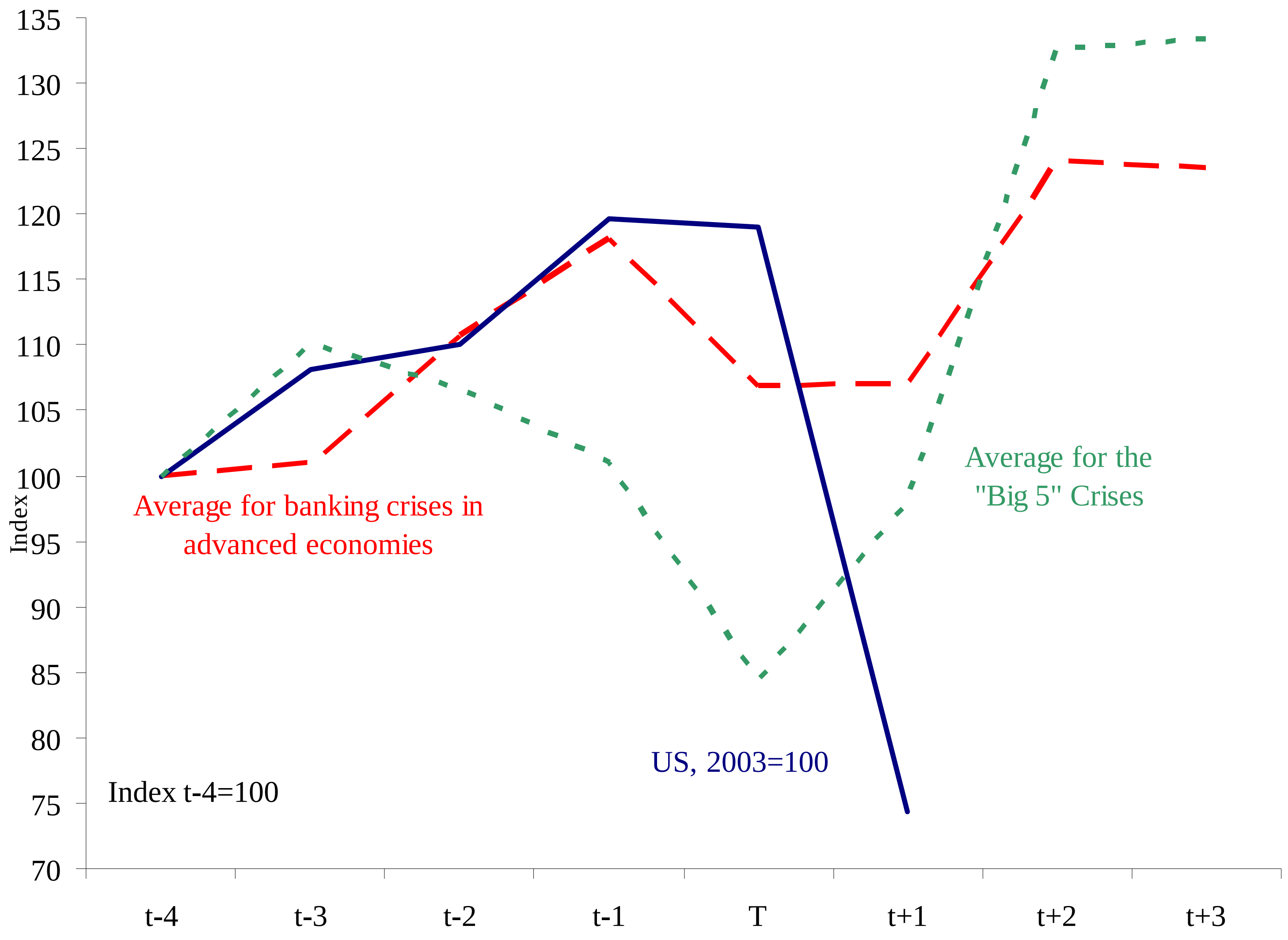
Real Housing Prices and Banking Crises



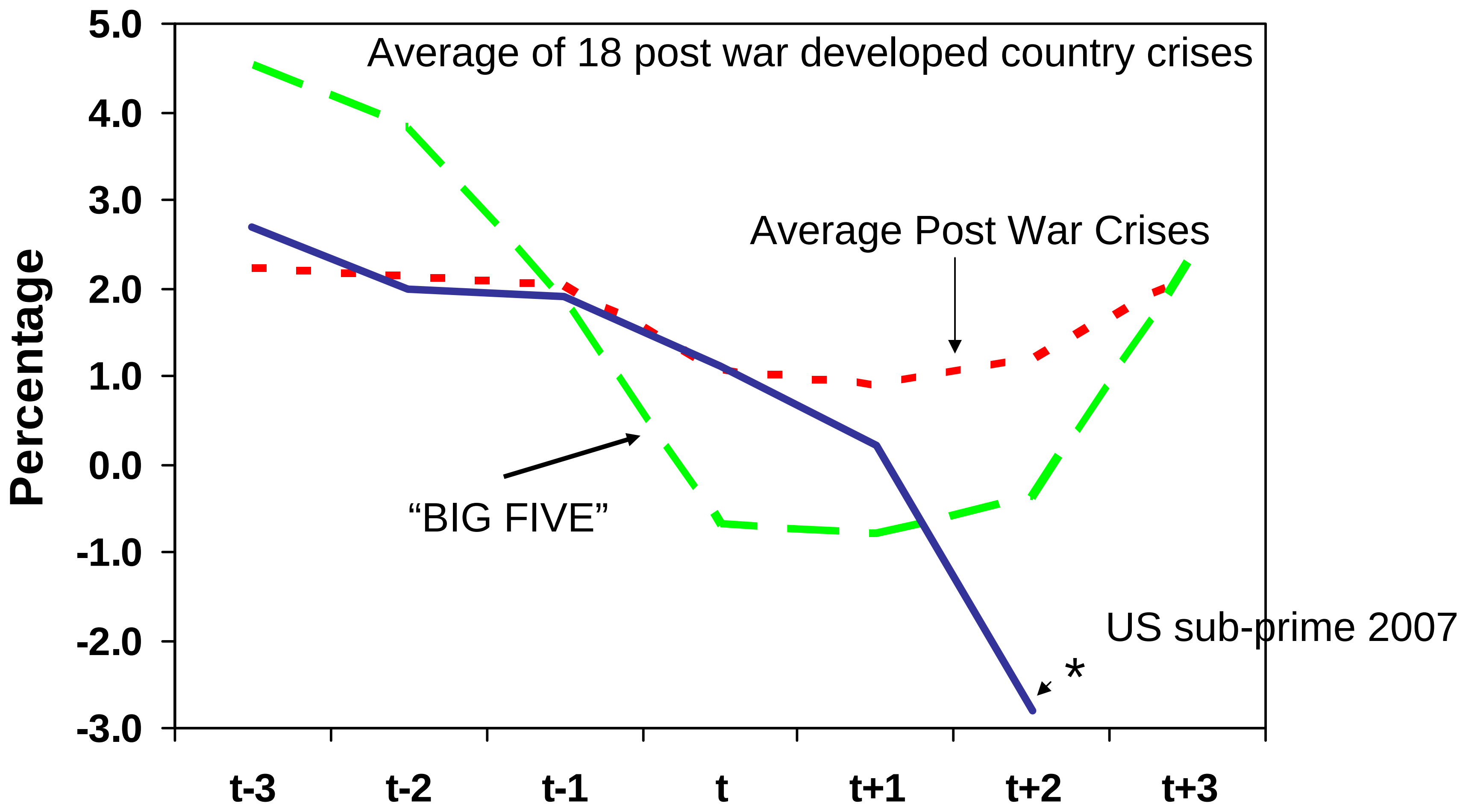
Reinhart and Rogoff, 2009

TODAY

Real Equity Prices and Banking Crises



Real GDP Growth Per Capita and Banking Crises



DEVELOPED COUNTRIES

TODAY

Source: Reinhart and Rogoff 2009

* Denotes consensus projection

Will fiscal stimulus work?

- Economists are not sure. Few precise analogies
  - In the Great Depression in US, massive increases in Federal spending were offset by cuts in state and local spending
  - Japan’s policy was erratic, there was never sustained coordinated action by monetary and fiscal policy.
  - Most other OECD countries have larger governments, higher taxes, bigger safety nets, so more “automatic” stabliizers, less need for active fiscal stimulus.

But financial system on life support

- Financial system on life support
  - Mark assets to market and recapitalize banks
  - Receivership likely necessary for most, possibly ALL, the biggest financial institutions
  - In the LONG RUN: ring fence a small number of large banks and heavily regulate them, severely restrict risky activities
  - Cast light regulation over hedge funds, insurance, other financial entities
  - Why can't US emulate Nordic Countries?

Why isn’t US administration willing to put and large banks in receivership?

- Legal obstacles to dealing with bank holding companies?
- Fear of Lehmann II?
- Trying to ensure that Republicans OWN recession…

Past financial crises suggest US authorities have been far too optimistic at every turn, even now…

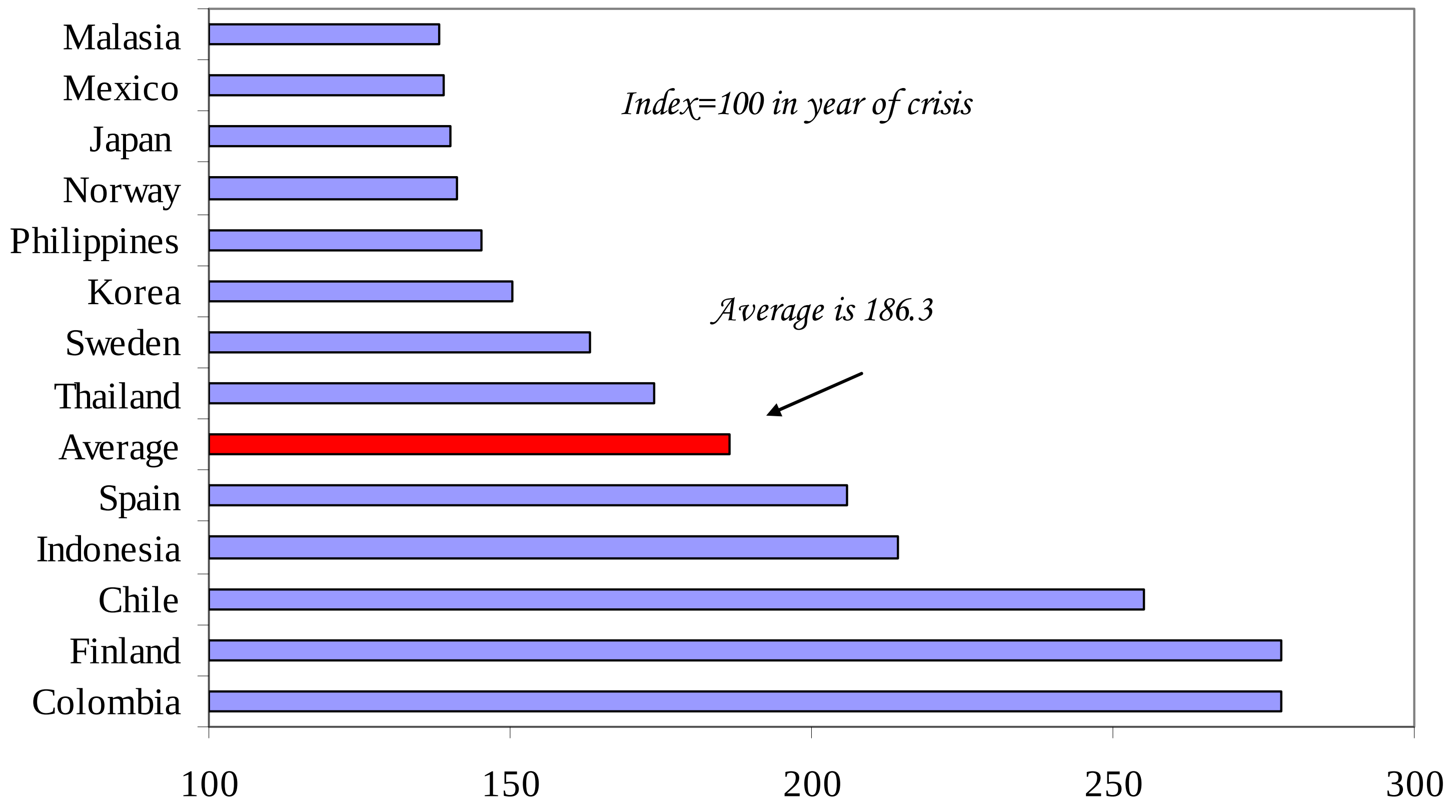
Past Experience with Severe Financial Crisis, Peak to Trough Changes

Spain (1977), Japan (1992), Norway (1987) Philippines (1997), Sweden (1991), Hong Kong (1997), Colombia (1998), Korea (1997), Malaysia (1997), Finland (1991), Thailand (1997) Indonesia (1997), Argentina (2001), US (1929)	Cumulative % change	Duration
Housing prices	**-36%**	**5** years
Equity prices	**-56%**	**3.4** years
Unemployment	**7%**	**4.8** years
Real GDP per capita	**-9.3%**	**1.9** years

Reinhart and Rogoff, 2009
"The Aftermath of Financial Crises"

Financial crises result in massive increases in government debt…

Cumulative increase in public debt in the three years following the banking crisis



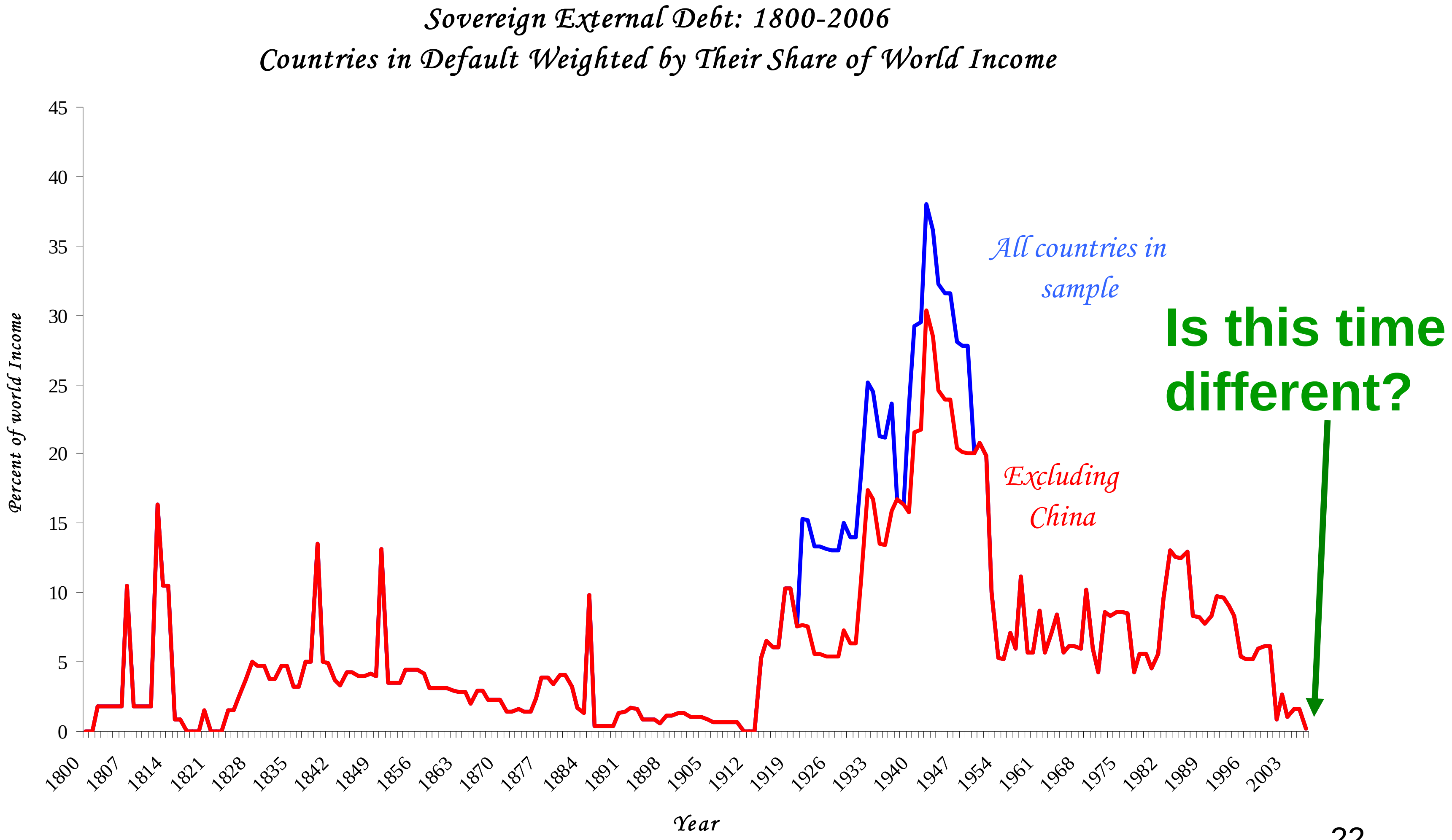
Reinhart and Rogoff, 2008

Risks and challenges facing Europe

- Risk of failure in large transnational bank
  - Adequate burden sharing arrangements are simply not in place.
  - How to ring fence defaults in Central and Eastern Europe.
- Difficulties in coordinating fiscal policy response in response to a likely deep recession.
- What if, two to three years from now, global long-term interest rates rise in the wake of massive increases in government deficits worldwide? Will countries with massive debt/GDP ratios be able to avoid default?

Will there be a chain of soverign defaults in 2009?

Sovereign Default Cycles 1800-2007



Source: Reinhart and Rogoff, 2008

A critical juncture for China

- Growth appears to be slowing markedly, perhaps into the 6% range. Risk of much worse.
- The more the government can continue to stimulate domestic demand, particularly consumer demand, to substitute for falling exports, the better.
- China’s size in the global economy made current model unsustainable anyway

Deflation or inflation ahead?

- In 2009, it will be very difficult to prevent deflation dynamic from continuing
  - Commodity price fall will continue to pass through global economy
  - Slack demand will put downward pressure on prices
  - Rising unemployment will put downward pressure on wages

Eventually government debt rise will make inflation very tempting

- Massive increases in public debt worldwide will put unprecedented pressure on fiscal resources.
- As interest rates rise – as they shall after two to three years of such huge spending and deficits – debt burdens will worsen, temptation to inflate will be irresistible.
  - Central banks cannot forever stand in the way

If faced with no alternatives, will Europe prefer inflation or default?

- Europe has a much more bank centric system than US, correpondingly, much higher debt to GDP.
- Much more resistance to inflation
- Very inflexible system
- Risk of default

Conclusions I

- US crisis to date has been driving down the tracks of previous deep financial crises
- The analysis of post-crisis outcomes gives sobering benchmark numbers for how unemployment, output and government debt will unfold
- Good news: duration of output declines typically only around 2 years
- Bad news: Most previous crises were more localized. But stimulus plans have good chance to work, at least to restore tepid growth.

Conclusions II

- Sudden stop in global credit markets will produce deep recession in most countries during 2009
- But Europe faces less deep structural adjustments than US, which needs both to fix its financial system and to adjust to a more socialist government