Economic Commentary

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The Global Economic Downturn: This Is Not Your Typical Recession

Understanding the magnitude and nature of the threat

- This is not your usual recession precipitated by restrictive monetary policy through high interest rates or build-up of excessive inventory in the manufacturing sector or over investment, the usual drivers of recessions

- This is a once in a lifetime occurrence which involves a **structural** breakdown that results in a deeper downturn and takes much longer to be resolved, usually 3-5 years

- Three global financial bubbles have burst at the same time: housing, equities and financial derivatives and they have taken down the banking system of the United States and the United Kingdom, the centres of global finance. The first two bubbles have knocked off $6 trillion in housing value and $9 trillion in equity value from the U.S. economy alone. The fall in the value of derivatives is unknown, because a high proportion of these instruments are booked in off-shore jurisdictions, are traded in unregulated markets and because of their opaque nature. Losses from these positions, some realized others unrealized are estimated at well over $1 trillion worldwide. In addition, a huge amount of value has been erased in financial securities such as commercial paper, corporate and municipal bonds. Trading in sub-prime securities has ceased and has resulted in unrealized losses exceeding $1 trillion and has blocked inter-bank lending. The banking systems of the USA and Western Europe have been placed on life support by central banks that have injected over $10 trillion in liquidity and capital to prevent the financial system from an outright collapse.

- Conservative estimates of the total losses on mortgage-backed sub-rime securities and other derivatives instruments equal or exceed the total amount of bank capital held by US banks, i.e. $1.4 trillion which means that US banks are effectively **insolvent**!

- The banking system of a country represents the heart of the economy while money and finance represent the lifeblood of a nation. With the financial system knocked down, the real economy begins to suffer because lending is reduced or cut-off entirely, because the cost of credit increases and because consumer and investor confidence collapse. Because of the extensive and widespread interconnectedness of the global financial system, the crisis spreads to other countries and the global economy. As economic activity begins to decline, it spills over to other countries through reduced imports (reduced exports for them), while the normal multiplier effects amplify the effects of the downturn and transmit them to the rest of the global economy. Even worse, since this is a **synchronous** global contraction, the downward momentum gathers force and turns it into a tidal wave of enormous destructive power.

- To date we have seen the following impacts on the world economy:

  The US economy has been in recession since December 2007, with no end in sight. It is on course to become the longest recession since the 1930s.

  The 4th quarter of 2008, US economic activity declined at an annualized rate of 6.2%, the steepest one-quarter drop since 1949.

  US unemployment has jumped to 8.1% (13.8% when we include discouraged workers). From November to February, the US economy has been shedding 650,000 workers monthly, a straight downward line and has lost over 4.4 million since the start of the recession.

  The economy of Japan has declined during the 4th quarter of 2008 at an annualized rate of 12.7%, the worst drop since 1974. It has been contracting for three quarters and this March it is headed for the fourth. Japan’s exports fell 13.9% during the quarter while in December, 2008 they fell 35% compared to the year before.

  The economy of the Euro Zone (EU-16) has contracted by 5.7% over the same period, the United Kingdom by 6.0%, Mexico by 10.3% and South Korea by 20.8%. Germany’s exports, the world’s #1 exporter, declined by 8.9% in December. South Korea’s and Taiwan’s exports plunged by 32.8% and 44.1% respectively in January.

  Last quarter’s are some of the steepest annualized rates of decline that have been experienced since the Great Depression of the 1930s,while the current quarter does not promise to be any better. Global economic growth as estimated by the IMF was projected at 0.5% for 2009 and is to be revised downwards, the lowest rate of growth since the organization was created in1945. Note that the IMF defines a global recession as only 3% growth.

- Clearly, this is not a typical recession when activity declines but structures remain intact. This is a downturn caused by a breakdown in the structure of banking and finance in the advanced industrial world and will not end until the structural damage is repaired, and this takes time to do even in the best of situations.

<u>Why we should not be complacent in Canada</u>

- As recently as November 27th 2008 when Jim Flaherty presented his economic statement to parliament the federal government was projecting a slight reduction in the rate of growth to 0.3% in 2009 and were projecting surpluses of $0.8 billion in 2008-9 and $0.1 billion in 2009-10. Likewise, the Bank of Canada in its October 2008 Monetary Policy Report (MPR) was projecting 0.6% growth in 2008 and 2009 and a rebound to 3.4% in 2010.
- In light of the drastic deterioration in the external economic environment, both the Finance Minister and the Governor of the central bank have had to change their projections. As we know, Jim Flaherty presented a new budget 60 days later on January 27th, 2009 and is projecting a contraction of –0.8% in GDP in 2009 and growth of 2.4% in 2010 and a budget deficit of $-33.7 billion in 2009-10 and $-84.2 billion over the 2009-14 period. Mark Carney in London this past weekend publicly admitted that the central bank's forecast for 2009 and 2010 is no longer valid and will be revised downwards in the April MPR.
- Since the March break begun, Statistics Canada reported that Canada's real GDP declined at an annualized rate of 3.4% in the last quarter of 2008, better than most of our trading partners and that both exports and imports fell during the period. Last Friday, Statistics Canada also reported that Canada lost another 82,900 jobs in February, on top of the 129,000 that were lost in January, pushing the rate of unemployment to 7.7% in Canada, up from 7.2% in January, 6.6% in December and 6.1% in July, 2008. Quebec's unemployment rose to 7.9% in February, a loss of 18,000 jobs in one month and is up from 7.1% last October.
- While governments have since announced major fiscal policy responses notably the $787 billion stimulus package in the USA and an additional injection of $18 billion in 2009 and $15.5 billion in 2010 by the federal government in Canada, the problem is that these measures impact the economy with an average lag of 6 to 9 months. In the meantime, there has been no cure to the structural damage incurred in the financial sector yet and the global economy is continuing to implode. The most recent figures coming out from all countries suggest that the rate of deterioration is continuing to accelerate while the most recent projections have been based on data that is continuing to be revised downwards.

- Although governments have reacted with appropriate measures in a timely manner, they are still not sufficient given the scale and severity of the downturn. First, the size of the stimulus packages is not enough to offset the drop in output occurring around the world. Second, they kick-in only after a substantial lag of time, in the meantime the economy is exposed to the ravages of the downturn. Three, there is a lack of sufficient global coordination in the way governments should respond to this crisis and there are persistent and pernicious protectionist tendencies still at work. Fourth and most threatening of all is the presence of **adverse feedback loops** between the real and financial sectors of the economy, and between the domestic and external sectors of economies.
- Although Canada has entered this crisis from a position of strength given our fiscal and current account surpluses, our high national saving and investment rates, our low external debt and our superior terms of trade we are still vulnerable to conditions in our external environment and we still have problems of our own. First, is our heavy reliance on external trade. The percentage of our output that depends on exports is around 37%, while nearly 78% of our exports flow to the USA. Second, Canadian households have one of the highest debt-to-income ratios in the world. In 2008, total consumer and mortgage debt represented 134% of personal disposable income, which makes both households and Canadian financial institutions vulnerable to a prolonged downturn. Third, we have had our own sub-prime problems in the form of the $35 billion asset backed securities (ABS) which our financial institutions have essentially defaulted on and our government shrugged under the carpet, not to mention sub-prime mortgages to homeowners especially in Western Canada. Fourth, commodity prices have collapsed and have resulted in a sharp deterioration in our terms of trade. Fifth, we have a chronic mediocre record in innovation and productivity growth and sixth, we are only reacting to events in the USA with a one year lag which suggests that the worse news is still ahead of us, not behind us. Canada is threatened to be side-swiped by conditions in the USA and the global economy.

What are the risks engendered by the global economic crisis?

- The first risk is that economic activity may decline much more than is being officially projected and may last much longer than is expected, both globally and in Canada. My opinion is that the contraction will be much deeper than projected by the Department of Finance and last until early in 2010.
- The second is that the recovery, when it arrives, will be slow and protracted and in the meantime the gap between actual and potential economic activity will accumulate. So even if technically conditions begin to improve, we will still feel poorer and insecure for a long time.

- A prolongation of the financial crisis risks feeding back negatively into the economy while a prolongation of the economic downturn risks feeding back negatively into the financial system, reducing household net worth and further undermining the solvency of financial institutions and further intensifying the financial crisis.
- As national economies contract simultaneously they reduce the volume of international trade and further drag down global production, employment and income for all countries.
- Nobody is in a position to really say at this moment how much deeper this contraction will go and how much longer it will last. No evidence has yet emerged to suggest that a decisive turning point has been reached in this downturn. Unless a decisive resolution to the financial system's problems occurs by ridding banks of their toxic assets and unless we see stabilization in housing prices and a resumption in investor and then consumer confidence, any sustainable recovery will remain illusive.
- Moreover, the longer the crisis persists and the downturn deepens, there is increased risk of further collateral damage to the financial system, with unforeseen effects on the rest of the economy.
- At the same time, either as a result of the above or on its own account, if the general public develops the perception that government authorities have lost the ability to manage the crisis then it is not difficult to imagine the prospect that a complete collapse in confidence occurs which then sparks a financial meltdown or widespread panic amongst the public which then spills over to the streets. The employment, trade and price figures that will come out over the next three to four months will tell us if we are indeed close to the tipping point and how far away from a meltdown we might be. For example, if product prices begin to fall on a sustained basis and a serious bout of **deflation** arises, that would be a sure sign of an impending meltdown.
- On the other hand, if government authorities manage to contain the crisis and engineer a recovery, we will face other risks. The first is that of **sovereign insolvency**, i.e. the risk that governments might have taken on too much additional debt that they cannot finance it or roll-over the existing debt through existing savings which can result in either higher interest rates and severe downgrades, inflation and even country default, or both. Since monetary policy in this environment loses its potency the risk of an uncontrolled bout of **inflation** becomes the most probable scenario.
- History is witness to many such episodes in different times and places. The hyperinflation of Germany in the early 1920s, the implosion of the Soviet Union in the early 1990s, the Mexican crisis of 1994, the South East Asian crisis of 1998, the Argentine crisis of 2001-2. I am not suggesting here that the federal government in Canada is confronting such a risk, but provincial governments which do not have the power to create money and whose public debt is very high such as Quebec's may be in for bigger challenges ahead than any one of us can imagine at the moment.

- Although Canada has entered this crisis from a position of strength and is not directly the source of the problems, it is still vulnerable to external shocks that will affect us. If the economic crisis proves to be much deeper and lasting than we expect, the USA –given its huge trade and fiscal deficits- may be closer to this outcome than anyone can imagine. If the USA resorts to printing massive amounts of new money (the Federal Reserve is already talking about "quantitative easing", fed speak for printing money) to cover its obligations, then we are sure to see a run-up in inflation, exchange rate instability and perhaps the collapse of the international monetary system itself. For example this January, foreigners sold more long maturity U.S. securities than they bought, a rare occurrence under normal conditions.
- As difficult as the prospect of a systemic breakdown may be to contemplate, and as low its probability of occurring may be at this moment, it remains a distinct possibility. Our postwar economy has been built on debt and the issuance of paper money. In 1944, at Bretton Woods, the USA pledged to convert its dollars to gold at the rate of $35 for an ounce of gold. On August 15, 1971, when it had become obvious that the USA had printed far more dollars than there was gold in reserve to back it up, the US reneged on its commitment and ended the convertibility to gold. Since then it has gone on to have massive trade deficits, print money and then borrow it to finance its fiscal and trade deficits and has contributed to the built-up of a mountain of debt around the world. Now, we may have reached the First Act of this "sovereign ponzi" scheme with the global financial crisis. The Second Act might be the global economic recession that we have entered following the events of September, 2008 on Wall Street, which can best be described as the financial equivalent of 9/11 or the attack on Pearl Harbor in 1941. To stem the tide the US central bank and the US Treasury assume so much debt that the U.S. government becomes insolvent. The Third Act might be that it resorts to printing massive amounts of new money to pay its bills that it brings global reflation and then ends up with the Final Act, the collapse of the U.S. dollar and the breakdown of the international monetary system itself.
- Who is to say that the above scenario might not happen. Did anyone expect that the most venerable Wall Street firms would collapse? That the world's largest bank, Citibank, largest insurance company, AIG, would become insolvent? Did anyone expect that Iceland would implode? That the largest banks in the U.K. would become insolvent and taken over by the government? Did you expect that the President of the United States would warn the US Congress of an impending **economic catastrophe** should it not approve its economic stimulus package last January? What is next? Do you believe that the worse of this crisis is behind us and the economy is soon headed for a speedy recovery? Do you think that the economic policy authorities are really in control of this crisis? They are clearly not. One thing is certain, that they are trying their best and using every weapon in their arsenal to fight it and avert a global economic

meltdown. Will they succeed? Nobody can really say. Nobody really knows. Do we still have confidence in our government institutions and their ability to restore order? Yes, we do, for now. But what if, what if they fail, despite their best efforts? What then? Clearly, to assume normalcy under the current conditions is not a rational option. One must contemplate the an-imaginable, the absurd, and plan for the worse while still hoping for the best.

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