



thinkpiece

Promoting debate and fresh thinking in the financial services industry

Coming up for air after the recession: Which countries and sectors will lead the recovery?

Vanessa Rossi

Summary

- The US, EU and Japan have all dived into an unusually synchronised and deep recession that will not reach its low point until early 2009. The OECD bloc will see a drop in GDP larger than the decline in 1975 or 1982, on a scale unprecedented since the 1940s. Emerging markets growth will also fall sharply, leaving world growth close to zero.
- This crisis is all the more surprising given the long run trend towards reduced volatility in economic performance, linked to the advent of automatic stabilisers and policy tools designed to manage the global financial system. The so-called “great moderation” of the last fifty years has ended not with a whimper but a bang. Damage to confidence and jobs will take time to repair while the loss in wealth will also make consumers more cautious in both their spending and savings habits.
- For all its problems, the US is still expected to be the first out of recession, driven by a mix of policy efforts, rapid restructuring of financial institutions and an incorrigible consumerism that Europe fails to understand.
- The emerging markets may have some black spots but on average these economies should avoid outright recession, with Asia, in particular, quick to benefit from any upturn in demand. This suggests that as soon as a glimmer of light is seen at the end of the tunnel – stabilisation in the US housing market and signs of an upturn in spending – the swing in sentiment will rapidly boost both financial markets and commodity prices.
- As the global economy and financial system emerge from crisis, the US and Europe will face new challenges in terms of global governance while the developing world increasingly dictates economic trends.

Number 10 (January 2009)

International Series Number 1

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CHATHAM HOUSE

CII Group



CII Introduction: The current economic recession that has gripped the world has arrived with considerable ferocity, and there seems little debate that the banking liquidity crisis has demanded prompt and decisive action from states and international institutions alike. The question confronting many policy makers and financial market practitioners alike is which countries and regions, as well as which sectors, will lead the recovery. As we begin 2009, Vanessa

Rossi from the global thinktank Chatham House has provided a timely and thought-provoking examination of the current international recession and where it will likely lead, especially with implications for the financial services industry. This paper kicks off a series of six international thinkpieces in association with Chatham House to be published over the coming months, covering a range of global business and financial themes.

The speed and ferocity of the global financial crisis has been unprecedented, as are challenges now confronting governments in response to it. After a tumultuous fourth quarter of 2008, policy responses are only now turning to the task of kick starting a recovery, and changes in long term trends will likely emerge as a shallow recovery begins later this year, dictating the global policy themes well into the next decade. Amongst these will be the growing power of the major developing economies, as signaled in the move to G20. However, the key support for the global economy in 2009 will be China, where the battle to maintain robust rates of growth continues to be waged.

Global recession to hit its low point early in 2009 – risks persist

The crash in the global financial system magnified the drop in consumer spending...

The crash in the global financial system over autumn 2008 suddenly and dramatically magnified the intensity of a recession that had gripped the major developed economies from the middle of the year, early symptoms of which were the sharp downturn in confidence and consumer spending across the US and Europe. The US, EU and Japan all dived into an unusually synchronised slump: the speed and severity of the fall in activity at the end of 2008 was alarming, with job losses notably accelerating even ahead of the holiday season and fears for worse to come in January. This clearly left policy adjustments trailing in the wake of the crisis instead of being ahead of the curve, that is, more action was really required during the first half of 2008 in order to be effective in time.

...creating a sharp and unusually rapid downturn

However once the financial crisis burst in mid-2008, immediate efforts necessarily focused on the rescue of the global financial system. While official interest rates and government bond yields have seen a dramatic drop in 2008, these cuts are taking time to filter into market rates and it will be even longer before any meaningful economic stimulus can be expected to emerge from the shift in monetary policy. Even more worrying, fiscal packages aimed at supporting economic growth in 2009 only started to emerge at the very end of 2008. There remains considerable uncertainty over the actual size and form of policy packages coming out of Europe (where member states are being encouraged to propose fiscal boosts worth some 1.5% of GDP), while the delay in the implementation of further stimulus policies in the US, linked to the presidential transition period, has only heightened fears for the economic outlook in early 2009. In addition, indicated targets of the new US administration, such as government led infrastructure investment, appear to be aimed more at regenerating growth in the medium term rather than the very short term, although very recent comments do suggest some leeway for short term tax breaks as well.

This speed has made national policy responses of marginal benefit in the short run...

...suggesting a long and slow recovery

Uncertainties over action in the US and EU, combined with doubts about other countries' scope for fiscal stimulus (eg in Japan) or scale of response (notably from China), mean that the size of the global fiscal response for 2009 is still unknown. This bodes ill for economic performance at the start of the New Year.

Figure 1: IMF Forecasts for OECD growth versus Recession Scenarios

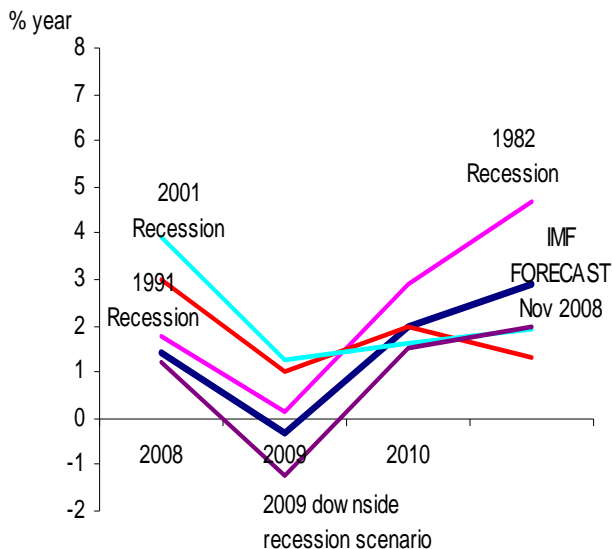
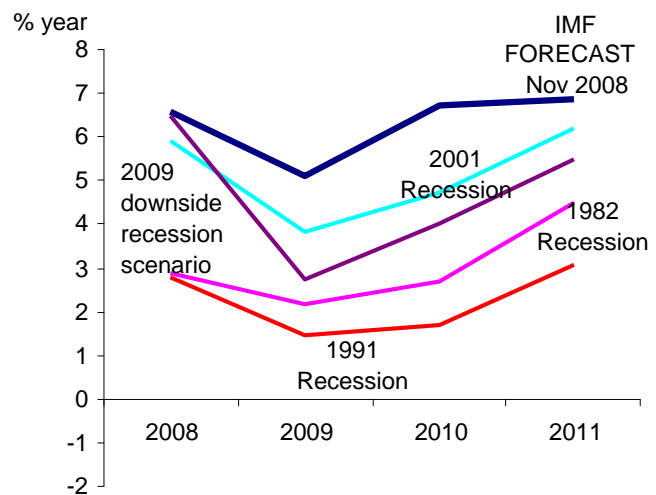


Figure 2: IMF Forecasts for non-OECD growth versus Recession Scenarios



Sources for both charts: IMF, November 2008 (with scenario estimates by the author)

The drop in GDP for the OECD bloc in 2009 will be the worst most people have ever seen.

The momentum of the downturn in late 2008 together with delays in policy taking effect suggest that the low point of the recession will be in the first half of 2009. This implies an unusually long recession, especially for the US where it officially began at the start of 2008. The OECD bloc will probably see a drop in GDP of 1-2% in 2009, larger than the decline in 1975 or 1982 and, indeed, unprecedented since the 1940s. Consumer spending will also fall by 1-3%, with world trade and investment tumbling by as much as 5-10%. Emerging markets cannot avoid impacts from the OECD wide recession and massive financial turmoil: their growth looks set to average no more than 2-3%, leaving world growth close to zero. This crisis is all the more surprising given the long run trend towards reduced volatility in economic performance, which can be linked to the advent of automatic stabilisers and policy tools designed to manage the global financial system. Nevertheless, the so-called “great moderation” of the last fifty years has finally ended, not with a whimper but a bang.

A global cycle in property and asset prices created a very coordinated crash and impacts on spending patterns...

The global boom-bust in the property sector and the worldwide impact of the crash in the financial system and asset values are key reasons for the simultaneity and severity of this recession and also suggest that the recovery could be exceptionally slow and risk-prone, especially given the threat of deflation (negative inflation) appearing in some economies later in 2009. The crash has already severely damaged wealth and confidence and is still causing losses in the financial sector, construction and property-related jobs. Adding to these problems, access to credit dried up in the midst of the banking crash and this situation is only gradually improving, largely thanks to provision of central bank funding and government intervention.

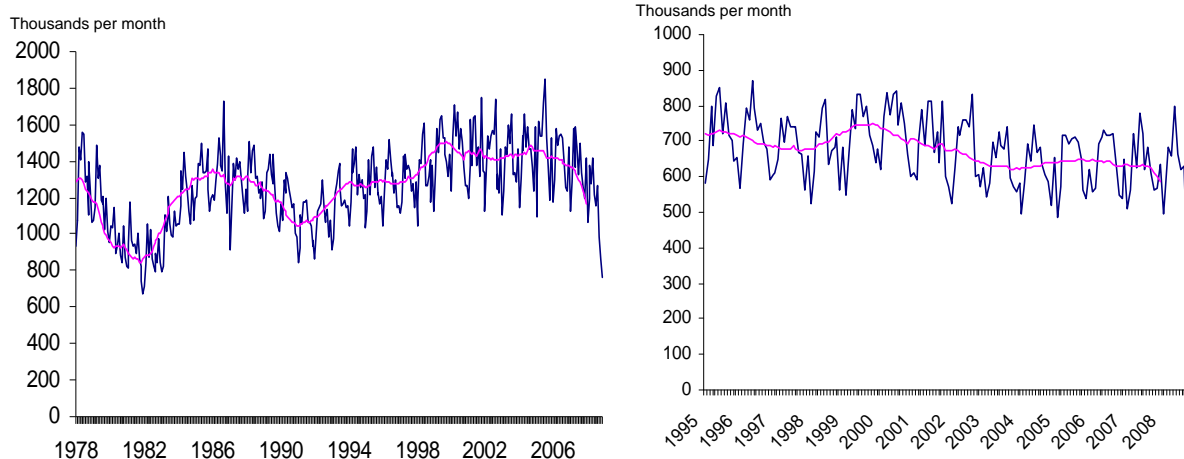
...continuing risks from rising job losses and threat of deflation

Plunging demand for cars and other consumer durables provokes price cutting and slump in exports for key suppliers...

Clearly the downswing was kicked off by the weakening in property markets that started in the US as far back as 2006-07. Not surprisingly, housing related consumer goods such as furnishings were one of the first segments of retail sales to show a sharp downturn. The accelerating deterioration in consumer spending through 2008 has also hit sales of cars and electronic equipment, with the impact on major suppliers being a key factor behind large double digit losses in exports for Japan and Korea in the autumn. In response to the slump in volumes, prices plummeted to attract buyers and the collapse in sales revenue also led to calls for bail outs from US car producers. As demand falls, cuts in industrial production and accelerated corporate consolidation are leading to yet further job losses and insecurity, generating a downward spiral in consumer sentiment, spending and economic activity. In these circumstances, many companies will be not just unwilling but unable to maintain investment spending in 2009. The construction sector has weakened already but will see further cuts. Business investment is only just starting to tumble but will drop sharply through 2009.

...investment spending will be another big victim of the crash.

Figure 3: Overall vehicle sales (left) in the US have collapsed back to levels of 30 years ago, domestic auto sales also sharply down (right)



Commodity prices slump as recession hits

...but threat of deflation could damage recovery prospects

Falling prices make debt burdens worse and impact on insurance premia and policies

A sign of low expectations for the global economy, commodity prices have slumped to about a third of their mid-2008 peaks – or around half the average level seen in 2008. Provided the price fall is passed on, this should benefit consumers. Indeed, consumer price inflation has quickly dropped back in line with 2-2.5% central bank targets (about half the rate seen in the summer of 2008). However, consumers are in no mood to spend more as they are raising savings in view of recession related risks. And even the fall in inflation is turning into a potential threat. As the effects of lower commodity prices and heavy discounting by retailers and car producers feed through to lower average consumer prices, there is a serious risk of a deflationary spiral (inflation turning negative). Rising unemployment and cuts in wages could feed into a dangerous downtrend in prices.

Deflation would be very bad news for economies struggling with high levels of nominal debt and restructuring in the financial sector – it would also start to impact on insurance valuations and policies, and on pension plans, coming on top of the impact of falling house prices and asset values.

What to watch for signs of recovery

History indicates recovery should start to emerge by late 2009...

...but it may be slower and weaker than usual

Key indicators to watch in early 2009 will be growth in China – now the bed rock of the global economy...

Recessions rarely last more than a year. Although periods of multiple shocks and large adjustment problems, such as the mid-1970s and early 1980s, have seen several years of low growth, and “double dips” in the recovery period are not unknown, *negative* growth rates rarely persist for a full year. According to the historic evidence, it is likely that a recovery will start to emerge later in 2009.

However, there are a number of reasons why this recovery could be both delayed and very shallow. Firstly, crises in the property and financial sectors typically take several years rather than months to work out, suggesting a very slow and risk-prone recovery – in this respect, the experience of Japan during the 1990s is an unfortunate precedent for how long and painful recovery can be. Secondly, the simultaneity of this crisis and recession around the world also implies that any recovery will be much more tentative than usual – it is more difficult to see where the new stimulus will come from and whether it will be strong enough to revive global growth.

Nevertheless, even allowing for additional risks, the most likely pattern of recovery will be based on:

- China maintaining growth through heavy policy intervention, keeping the world economy at least ticking over in 2009: in terms of action, Chinese policymakers are implementing a large fiscal package (possibly worth nearly 10% of GDP in 2009), interest rate cuts and quantitative easing to boost loans growth
- A policy led effort in the US producing signs of a pick up in the US economy by late 2009, which, in turn, would help to boost growth in Asia: critical factors here

...and the impact of US policy announcements – can the Obama team restore optimism and growth?

The commodity cycle will be quick to respond to hopes for recovery...

...but developing economies with big external deficits and debts could face very deep and prolonged recessions – victims of both credit shortages and the return of risk aversion

The US at risk of a below par recovery compared with the usual big bounce back – will take time to absorb all the excess housing stock and foreclosures

Consumer durables cycle may also be slow to pick up in spite of recent steep drop in sales

Continued declines in prices may even persuade consumers to delay purchases

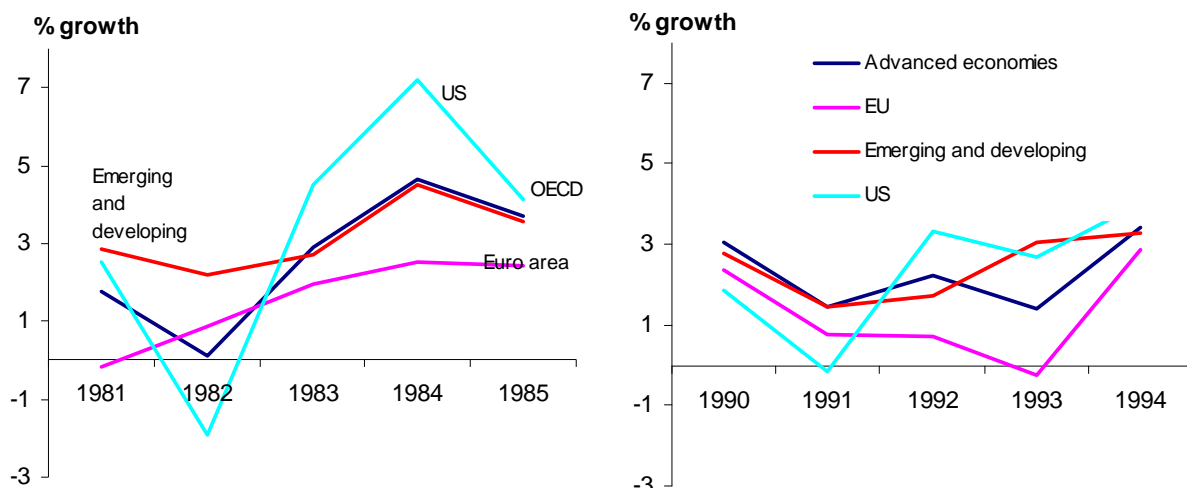
will be signs of stabilisation in the US property market and rising consumer durables spending, including an eventual recovery in car sales

- With the twin engines of the US and Asia starting to fire up, these would reignite demand for commodities and improve confidence around the world economy: key indicators would be a steep pick up from trough for commodity prices
- Results in the US might encourage greater efforts to restart growth in Europe as well, as initial attempts at a Europe-wide reflation package (announced in December 2008) were slow off the block. ECB rate cuts also lagged behind the US, the UK and other European countries, although some argue deeper cuts have little impact anyway
- Provided these Asia-US-European policies get started fairly quickly in 2009, so that a recovery starts to look feasible for the end of the year, damage to growth in many other regions might be limited – for example in Latin America and the energy producing countries, which have scope to withstand a short downturn but not a prolonged slump
- Unfortunately some countries will face severe turbulence in 2009 and may take longer to recover – those with large balance of payments deficits are most vulnerable and the queue for IMF aid is growing already.

This recession has already been long by US standards – it officially started at the beginning of 2008 and a recovery would typically start to emerge by early 2009. Unfortunately, the recession “clock” was reset by the advent of the financial crisis. So, counting recession as starting in late 2008 indicates that a recovery might not emerge before early 2010. This would also allow more time to absorb both the excess stock of new homes and the new wave of foreclosures flooding the US housing market - and more time for a revival in consumer spending.

However, the US consumer durables cycle, including car sales, could take longer than usual to regain normal levels after a very severe slump, with growth only restarting with any vigour by 2010-2011. Indeed, recent peaks for annual unit sales in US homes, cars and big ticket household goods may not be revisited for many years. The recovery could be delayed even longer if a bout of deflation emerges – this could further spook markets, damage confidence and encourage people to put off purchases of durables. The nature of the crisis in the financial sector also means that there are substantial risks of further setbacks as institutions struggle with the aftermath of the 2008 crash.

Figure 4: Historic performance suggests the US typically bounces back strongly after one year of recession – but many fear this will not be the case in 2009



Asian manufacturers will be quick to benefit from any upturn in global demand and...

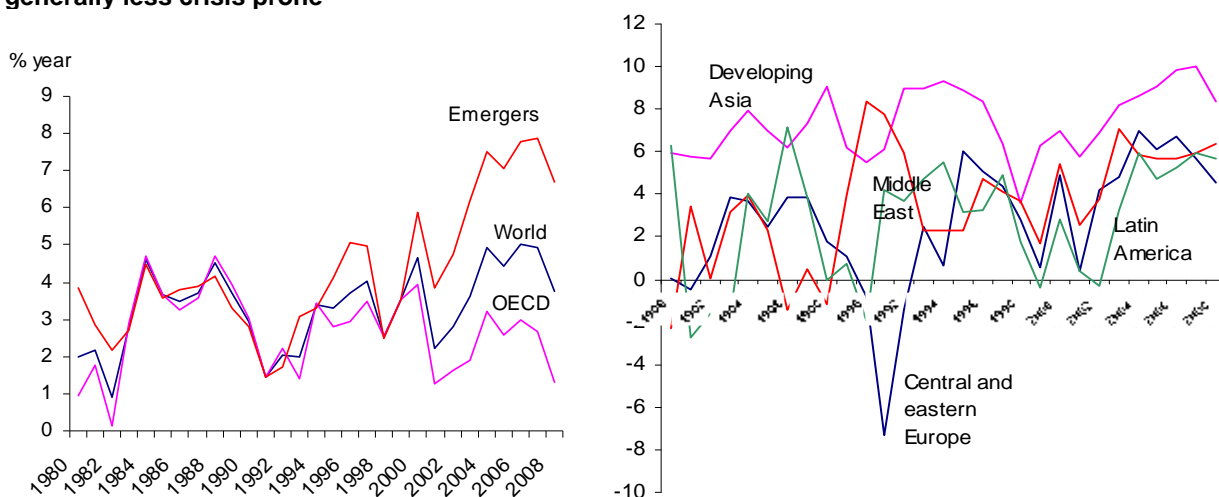
In spite of the caveats, most analysts are cautiously optimistic that at least a weak recovery will begin to emerge in the US by 2010. This will most likely promote yet another surge in growth across the emerging market world. In particular, a global upturn will be strengthened by the potential for a rapid resumption of growth in Asia itself. This is due to the region’s relative strong financial position, which has been

maintained since the recovery from the Asian crisis of 1997-98. This is evident in terms of typically high FX reserves, low external debt, high personal savings rates and positive current accounts (or low deficits) and also relatively robust banking and public sector finances. Local consumers will also benefit from lower commodity prices, inflation and interest rates. Intra-regional trade already accounts for about half of Asian trade and there remains further scope for development in local consumer growth and intra-regional linkages. In addition, Asia is still very competitive and the region will remain the powerhouse of global manufacturing – benefiting rapidly from any pick up in demand anywhere in the world.

...the impact will feed through to Asia's suppliers of energy and raw materials – may limit their risk of recession

Once Asia picks up, this will quickly stimulate energy and other commodity demand, kicking off a new round of growth across the other emerging markets from the Middle East and Africa on one side to Latin America on the other. Many of these developing economies are also on a much stronger footing than they were in the 1980s and 1990s. Several years of strong growth, with relatively prudent fiscal, monetary and financial policies, have generally promoted more stable growth conditions and a much lower inflation environment. It is impossible to avoid negative impacts from the OECD crisis and the very widespread boom-bust cycle in property and finance but the situation for most developing countries is still far better today than it was going into previous global downturns.

Figure 5 and 6: GDP growth over the longer run shows emers riding high, Asia in the lead and generally less crisis prone



The greatest concerns are for Eastern Europe – potentially the new “Latin America” on the EU’s doorstep

The main exception to this relatively rosy view is Eastern Europe. The credit stoked consumer boom, excessive property speculation, ballooning external deficits and hefty foreign debts have created the risk of a debt crisis similar to that seen in Latin America in the 1980s or the more recent peso crisis in Argentina. The recession will probably be very severe and prolonged in a number of countries. To some extent, this will have feedbacks on to the EU economies and there could be further risks ahead for the banking sector.

Global industry trends shift from one recession to another: does this imply “regime change” is in view?

New era - new themes?

Some countries and sectors come out of recessions better than others, as shown by historic examples, and past episodes of turmoil have also seen significant changes in the key “themes” for the world economy. For example, after the dotcom bubble burst, the IT sector fell out of favour while the energy sector started to gather strength from unexpectedly strong increases in demand, culminating in the price surge of the last couple of years. But in the early 1980s, it was oil that fell out of favour, while the transfer of manufacturing industries started to take off, helping drive a long boom in the Asian economies that contrasted with the de-industrialisation of the US and Western Europe and the debt induced collapse in Latin America. Eastern Europe’s took the turn in the early 1990s to be savaged by the closure of “old” industries and scrapping of excess and ageing capacity, while the new consumer boom in the West encouraged Asia’s expansion in consumer

electronics. These twists and turns are important for the businesses that feed from them – including finance and insurance.

Declining role for the “old world” in manufacturing – power has passed to Asia – but are remaining roles in global governance, finance and technology also at risk?

Today, the world economy can be crudely characterised as a production system in which raw materials from the resources economies feed into the manufacturing powerhouse of Asia, which then exports to the US and EU markets and the rest of the world. In exchange, the US and EU exports technologically advanced goods and services as well as providing financial investments, mostly in the form of government bonds for central banks’ foreign exchange reserves but also including equity investments for sovereign wealth funds (SWFs) and high net worth individuals. How does this “overview” compare with historic trends and what might this tell us about prospects for the next upswing from 2010?

Consumer trends more reflective of demand in Asia and emerging markets – less dominated by the “west”

The trend towards Asia becoming the manufacturing centre of the world economy essentially began with the rise of Japan as a modern industrial power but then progressed to Korea by the 1970s and 1980s, with the focus very much on heavy industry and the consumer durable of the 20th century – the car. Other parts of Asia grew in textiles and light manufacturing such as toys and home goods – the initial focus of trade for Hong Kong but also other Asian “tigers”. However, growth in consumer electronics and the advent of mass market computers and mobile phones dramatically altered the industrial base of the “tigers”: Asia has become the hub of production for most of these goods, competing with itself rather than the rest of the world. This position is unlikely to be challenged – in terms of its grasp of these industries and its competitive position, Asia has ample scope to further develop the role of dominant supplier, increasingly selling to its own consumers and other emerging market economies and becoming less dependent on western consumers over time. The next decade may therefore be more about emerging market consumers and their tastes and trends, with the “west” taking a back seat.

The “west” still has an advantage in global governance – but needs to preserve its role by modifying the system in light of the 2008 crash, reviewing demands for access to technology and finding more seats at the “top table”

What role will be left for the “old world”? This analysis highlights the functions that both the US and EU continue to serve as the centres of “global governance” in a broad sense, covering banking and finance, security and also development and access to leading edge technologies.

Critically, these roles are not simply defined by economic power and factors such as cost competitiveness but depend on a relatively complex mix of social, political, historic and geographic influences that have, so far, proven hard to replicate elsewhere. Nevertheless, the position may be under greater threat today due to the challenge posed by the financial crisis. And there is increasing pressure today to modify the grip of the “old world” on access to technology.

...so 2009 will be a key year changing the rules

How these challenges will be met in the realm of global financial governance will already be a significant issue in 2009: the growth industry in financial regulation and oversight will continue under an urgent new mandate. The “old” world needs to come up with both new solutions and a clear role for itself if it wants to preserve its leadership in global governance and its key functions in financial services.

If you have any questions or comments about this publication, please contact the CII Policy & Public Affairs team on ☎ 020 7417 4783 ✉ laurence.baxter@cii.co.uk



Vanessa Rossi is Senior Research Fellow in International Economics at Chatham House. She has extensive experience in international economics and financial market analysis gained from a career that has spanned the city, major institutions (the European Commission and also consultancy for the World Bank and US government), academia (Princeton University) and research institutes.

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