Swedbank

To the Point

Discussion on the economy, by the Chief Economist

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How to limit post-recession stress

The financial crisis and the global recession have abated, but medium- and long-term challenges remain in the world economy, especially in the OECD countries. The economic situation has improved, but it is way too early to uncork the champagne bottles.

This version of *To the Point* analyses the different phases and, in particular, the aftermath of the crisis. The last part of this analysis is more geared towards discussions on the actions needed to reduce the post-recession stress. They include: Setting budget goals and expenditure ceilings, communicate exit strategies, combine budget consolidation with structural reforms, improve the functioning of labour markets, and deregulate services markets while re-regulating the financial sector. In addition, policy makers must be more aware of the dangers of building up new imbalances.

Beware of the illusory calm

We start by identifying the five phases of the crisis and the global recession. Currently – being in the third phase – the situation has calmed down due to support from central banks and governments. However, the two upcoming phases could become messy indeed.

1) In the *first* phase, the US housing market collapsed, leading to a broad financial crisis, including a loss of trust, liquidity constraints, and insolvency among financial institutions involved in subprime lending and derivatives. The rules of the game, after the financial sector had been deregulated in the late 1970s and the 1980s, included bailing out and moral hazard. When Lehman Brothers filed for bankruptcy, however, the rules of the game changed, leading to fear, and to new priorities regarding risk and activity. The only way to reduce this fear was to make sure the pre-crisis rules of the game were restored. Accordingly, after implementation of stress tests and assurances of new bailouts, the financial market began recovering slowly, although deleveraging remains. The biggest and most interconnected banks are now getting bigger and even more connected …

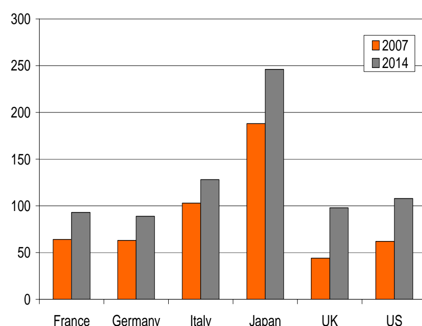
2) The *second* phase focused on the real economy, as demand fell and layoffs on the labour market increased dramatically. Despite deployment of a great arsenal of weapons to counteract the recession, demand fell more than in any year after the Second World War. Subsequently, however, interest rate cuts, quantitative easing, liquidity support, and large fiscal stimulus programmes helped out, actions supported by both monetarists and Keynesians.

3) The *third* phase has started out well. The valuation on the stock exchanges has increased since spring of last year. The real

economy started to improve during the summer in some countries (e.g. Germany) and towards the end of 2009 in some lagging ones (e.g. UK). At the moment, an illusory calm prevails in the real economy.

The calm is illusory because, without the stimulus, the recovery would be threatened. When stimulus programmes are about to cease, growth in various markets will most likely be weakened. The “U-shaped” scenario may very well turn into a “W-shaped” scenario. A double dip is especially likely if the exiting of stimulus is not managed carefully. Already, concerns are building up on financial markets about the withdrawal of the stimulus and the build up of large fiscal debts, resulting in volatility and falling share prices.

Chart 1: Public debt as a share of GDP, 2007 and 2014, for selected OECD countries (%)



Source: IMF

4) So far, the financial sector will have been given carrots but no sticks. In the *fourth* phase, sticks begin to be applied. When re-regulation is carried out, growth will be held back as it is likely that new regulations will affect risk-taking behaviour and market efficiencies. On the other hand, one of the reasons for re-regulation is to create a more stable growth environment, and thus the growth rate will most likely have to be somewhat lower. In this fourth phase, the public debt levels in many OECD countries will have increased to undesired levels above 100%, with the risk that growth will be dampened. Reinhart and Rogoff show in their paper from last year, *This time it is different*, that growth is affected negatively if debt levels rise above 90% of GDP.

5) In the *fifth* phase, risks regarding price developments may be added to the growth challenges. At the moment, the recovery is matched by slowly increasing inflation expectations, and the concerns about ugly *deflation* have faded. However, with a double-dip or W-shaped scenario, the deflation concerns could return, and, as in Japan, slow growth and large output gaps could be combined with deflation or low inflation. If, on the other hand, the recovery turns out to be robust, and banks start lending, *inflation* concerns would grow. *Stagflation* seems less likely, as it is hard to pass on higher commodity prices to consumers when demand is low. A return to *great moderation*, with high growth and low inflation, is also less probable. The most probable outcome seems to be low growth and low inflation in most OECD countries, but with overheating problems and high inflation concerns in many emerging markets.

What earlier crises have taught us: be prepared!

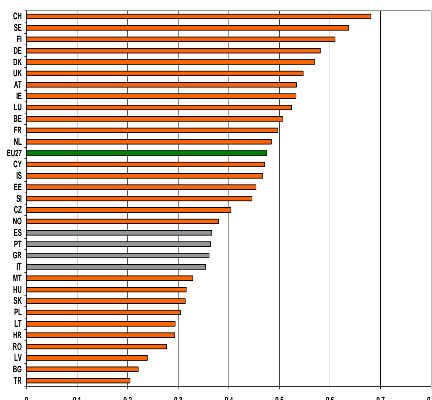
Many emerging markets with dark memories of past financial crises have learnt from these experiences and tried to build up large surpluses in budgets and current accounts in order to be prepared for the next collapse. The same goes for the Nordics (Iceland excluded). Compared with most countries in the euro area, Nordic countries are emerging from the current crisis with better fiscal positions, despite having the tools of both discretionary spending and automatic stabilisers.

After the crisis at the beginning of the 1990s, Sweden implemented reforms in order to improve budget discipline. The goal was to run a fiscal surplus in relation to GDP over the business cycle. Demographics were regarded as being the motivation for generating savings, as the Swedish working force was expected to start declining. However, also important was the goal of avoiding dependence on other countries and international institutions, as had occurred during the previous crisis.

The best approach to establishing fiscal discipline is to set up budget goals and expenditure ceilings well in advance. Germany has now joined the Nordics in following this approach, and this would also be a good recipe for other countries, such as the US (where President Obama has started by proposing expenditure ceilings), Greece, Portugal, Spain, and Italy. Achieving budget goals may not only help to avoid the next crisis, but it may also help to restore credibility in the present turmoil.

Financial crises often accompany "the four bads": bad policies, bad regulation, bad bankers, and bad luck! Earlier crises have taught us that it is then important to restore confidence both internally and externally. To improve regulations and to strengthen institutions is crucial, especially as many people will be faced with austerity – diminishing possibilities of living a good life – and need to have some trust in politicians. In Sweden, political parties tried to cooperate more than usual, and it actually led to some agreements across party lines, both during and after the crisis in the 1990s.

Chart 2: Innovation in the EU-27, ranking according to European Innovation Scoreboard 2008



Source: Pro Inno Europe, Inno Metrics

Competitiveness issues seem to have been neglected in the southern parts of Europe for a long time, but it is not too late to start improving the situation. Investing in R&D and education, language and IT competence, as well as creating more flexible labour markets, can go far in fulfilling this task. To stick to old methods (devaluations and bailouts) will not be possible anymore. Internal devaluation is the medicine for countries taking part in the EMU, when cost structures are too high to attract investments. The Baltic countries are choosing this approach before adopting the euro, but quite a few countries may have to go through internal devaluations despite having been members for years.

Sweden carried out a number of reforms during and after the crisis in the 1990s. Several windows of opportunity for reform opened up, such as carrying out a pension reform, making labour markets more flexible, improving wage creation, and strengthening policymaking (both monetary and fiscal policies). It may not be an instant comfort for the present crisis-stricken countries, but at least this opportunity provides a possibility to be prepared for the next crisis (which could come sooner than later …).

Apply brakes and gas simultaneously – is it possible?

Even if the aftermath of the financial crisis and the recession so far has been quite pleasant, there is a clear risk of post-recession stress building up as we approach the fourth phase, with higher public debt, less stimulus, and re-regulation of the financial sector.

Fiscal policy has had to shoulder the burden of stabilising the economies, as monetary policy has not functioned as well as usual. One approach would be to view the building up of public debt as a non-issue, as the debt burden will decrease when growth returns. It is true that it is better to use fiscal policy to counteract the downturn in demand for goods, services, and labour than to watch the economy fall into a black hole. The question is if money is well spent or not. Often, debt increases more than necessary as interest groups demand compensation for casting votes on the programmes.

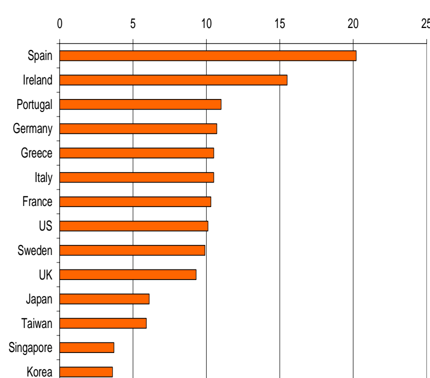
Another issue is if expenditures increase temporarily, or more permanently as in the US at the moment, because this will make it harder to consolidate budgets later on.

As long as the growth climate is weak, it will be quite easy to finance the public debt accumulation. But there are contradictory sets of expectations (bond markets vs equity markets). Or, as the Economist recently wrote:

> "Financial markets are dependent on extraordinary amounts of government stimulus. But that stimulus is in turn dependent upon the willingness of markets to finance governments at low rates. They should be willing to do so only if they believe that growth prospects are poor and inflation will stay low. But if they believe that, investors should be unwilling to buy equities and houses above-average valuations. At some time – maybe in 2010 – those contradictions will have to be resolved."

Budget consolidation will have to start being carried out within a couple of years in many countries, and this constraint will affect growth in these countries, as well as in other countries dependent on trade. Cutting expenditures in the most effective way, as well as increasing the taxes that affect growth in a less negative way, will be the challenge. There is more than one way of consolidating: consider the experience of Canada in the 1990s, when cuts in expenditures were combined with tax cuts to get more support from the public, thus putting on the brake and stepping on the gas at the same time!

Chart 3: Unemployment rates in selected OECD countries 2010, % of the labour force



Source: IMF and Swedbank

Labour markets act differently in the US and in Europe. *Kurzarbeit* may make more sense in Germany than in the US, although we have not yet seen the result in Germany after structural adjustment. Labour hoarding may be more effective if competent labour is scarce and growth is coming back in that particular sector, than if production is moving to emerging markets and a more dynamic labour market is needed.

As the industrial sector has been weakened by the crisis, Europe must increase ambitions on how to provide an effectively working services sector, well integrated in the whole of Europe. Deregulation of services is needed as much as re-regulation of the financial sector.

Structural adjustment has worked quite well over the years, as old production has been replaced by new sectors/companies. The German economist and sociologist Werner Sombart wrote about "creative destruction" in 1913, and Joseph Schumpeter brought the concept to the Anglo-Saxon world in 1942, when he made it part of his

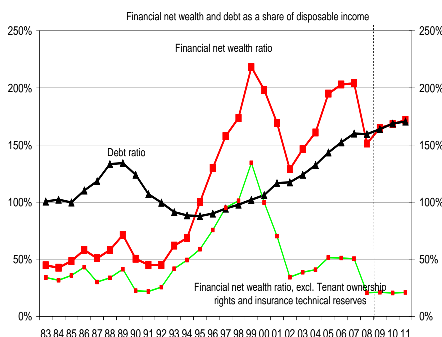
economic theory. The concern is that structural adjustment works better if the financial sector can provide risk capital and act as an intermediary allocating capital effectively. Because the financial sector may not be functioning in this way during this cycle, there is a risk that structural adjustment will not work as well in the OECD area as usual, and that opportunities for creating new production will thereby be lost, as the old production is moving to emerging markets. We need to find ways to reduce this concern!

Be cautious of new imbalances

It is important to distinguish between *increasing tensions* and *triggering factors*. For many years, increasing tensions in the US household sector, housing market, and current account were possible to identify. However, just like an aeroplane only crashes when three-four incidents occur simultaneously – not with only one incident, which pilots usually can handle – tensions lead to a financial collapse only after several triggering factors occur.

At the moment, tensions are increasing on several markets. In China, overheating is a concern, as capital inflows mix with high credit growth and optimism. In India, inflation is also taking off, especially regarding food prices. Commodity prices have risen extensively, and some speculation is probably included even if fundamentals in these markets are driving demand and increasing prices from crisis levels. The stocks do not look so inexpensive anymore, and when stimulus is pulled back, various markets could hit the wall, and asset prices could fall.

Chart 4: Debt and net assets as a share of disposable income for Swedish households



Source: Statistics Sweden and Swedbank

In Sweden, households are borrowing at high speed. The debt ratio is some 160% (household debt in relation to disposable income) and will approach 200% next year if present credit growth rates keep on. Many observers are not worried as banks never before have been hit by households' real estate, but rather by commercial property. Perhaps so, but tensions are building up that, with the right triggering factors, could lead to lower retail trade and private consumption growth, as well as falling house prices and problems for banks. The triggers? A global double dip and a new recession, more severe structural adjustment affecting industrial companies and employers… There are room for more surprises as we go forward …This is not the way to handle post-recession stress!

There are ways of cooling down credit growth when monetary policy is extremely expansionary – ways that, instead, consider long-term sustainability. Regulations and taxes can be used. But what politician would stop a cheerful party during an election year – and commit a political hara-kiri. Can't think of anyone…

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