

Scenari

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special
issue



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The financial effects of the credit crisis have already materialized around the world. Now the impact on the real economy of the needed de-leveraging in the financial sector has started to unfold.

Most industrialized countries were officially declared to be in recession in the third quarter of 2008, with indicators deteriorating rapidly also in emerging markets. World growth is projected to be back on track only by 2011.

In response to the economic slowdown and financial markets difficulties, monetary policies have become expansionary around the world. However, with many central banks close to a "zero rate" stance and the need for timely measures, fiscal policy is back to the driver's seat.

While fiscal packages announced so far are substantial, it is their quality more than their size that matters. Measures that are well targeted, reduce distortions, and can be more easily removed when the crisis is over are least risk-prone. In both advanced and emerging economies the challenge is to avoid a rapid growth in public debt, which could undermine investment and economic potential and put upward pressure on interest rates.

Deficit-Spending The Crisis Away? The Devil Is In The Details

The 18-month old credit crisis is now being transmitted to the real economy.

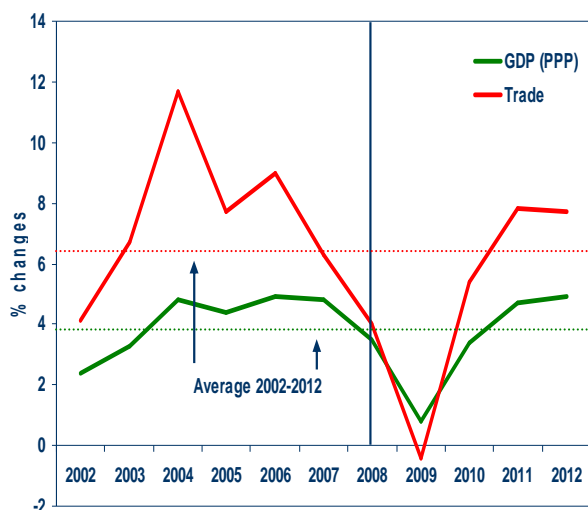
While the financial effects of the turbulence in credit markets have already materialized, as stockmarkets have collapsed and money markets remain tight around the world, the impact of the needed de-leveraging on the real economy has just begun to unfold. Several industrialized countries were officially declared to be in recession in the third quarter of 2008 with macroeconomic variables deteriorating rapidly. Moreover, both quantitative and qualitative short-term business indicators have plunged over the last three months almost everywhere in the world. Expected data for the last quarter of 2008 are not favourable and leading indicators point to a deepening of the crisis in the first half of 2009. The issue is now not anymore whether there will be a recession on a global basis, but the timing of the eventual recovery in light of the policy measures which are being adopted by various governments.

World growth is projected to be back on track only in 2011.

Oxford Economics projects real growth in global economic activity to fall below 1% in 2009, the lowest level since 1982. Quarterly growth rates are expected to reach a bottom in the first quarter of 2009 and remain weak in the following part of the year. The recovery should only materialise in the second quarter of 2010 with global growth bouncing back to about 3.5% on average for the year. By 2011-12 world GDP is expected to return to trend growth again. As global demand slows, international trade will be mostly affected, falling by 0.4% in volume terms: a signal of de-globalization, at least in the short run. Weak private domestic demand, particularly in advanced economies, will be

the main drag on imports and hence on cross-border sales. However, the financial channel is as important as the real economy: as undercapitalized financial institutions restrict credit supply, deals become more expensive and more difficult to close because of insufficient levels of trade finance. Global trade is expected to recover only in 2010 and reach growth rates above 7% in the two following years.

A V-shaped crisis



Source: Oxford Economics

G7 countries will be hit hardest, but emerging markets will suffer too. Economic performance is expected to be one of the worst in the last sixty years in the advanced economies. Real GDP growth is projected to contract by 2% in 2009 in the G7 group, with France and Canada being the only countries where the decline should be more modest. Although more resilient, the main emerging economies will not be able to decouple. Russia, which is experiencing a credit crunch and relevant capital outflows, is expected to be the worst affected in the BRIC group. In 2009, growth will be capped to about 1.5%, a fourth of the average expansion rate recorded in the previous ten years. The Brazilian economy will also slow its development as global demand contracts, however its more diversified and mature industrial infrastructure will help offset the worst consequences of the crisis. China and

India are projected to grow by 7% and 5% respectively, in 2009. While these are significant rates of expansion, they are well below long-run trends as a result of a severe contraction in export growth, subdued investment, and limited contributions from domestic consumers.

Monetary policies have become expansionary. In a context of rapidly decreasing commodity prices – from their peak in July – and declining inflation expectations, central banks have switched their focus on economic growth by cutting markedly their policy rates. This resulted substantially in a “zero rate” stance in the United States, whose monetary rates are now aligned to Japan. There is some more room to cut rates for other central banks in industrialised countries, but nominal interest rates are already low by historical standards.

The standard monetary tools are losing their steam. The effects of the latest aggressive cuts in policy rates have not yet been felt into the real economy, as the monetary transmission channels require some time (9-14 months in average). However, the demand stimulus is most needed over the next three months. The policy rate is not the only instrument central banks have to support markets. Since the beginning of the crisis, they have in fact injected liquidity in the system and bailed out troubled institutions in several ways by expanding their balance sheets. As the current crisis deepens, “unconventional measures” (e.g. printing money) cannot be ruled out. Nonetheless, monetary policy alone is not enough and some emerging countries with weaker fundamentals cannot even count on that in order to avoid a worsening in capital outflows and downward pressures on their currencies.

The driver seat has been taken by fiscal policies. Many governments have announced special plans in order to alleviate the real effects of the financial crisis. It is clear that countries running fiscal surpluses or with a low debt-to-GDP ratio are better positioned to use the budget as a counter-

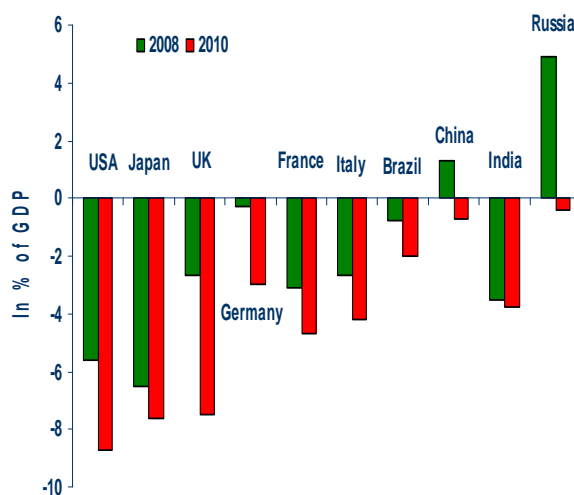
cyclical tool than others. Fiscal plans have been recently announced by many governments including the United States (7% of GDP), Japan (4.5% of GDP), and BRIC countries (e.g., China, 14% of GDP in 2009-10). Also the largest EU economies have launched discretionary fiscal support measures for 2009. According to Barclays Capital, such support should so far be higher in Spain and the UK (1.8% and 1.2% of GDP, respectively), while for Germany, France, and Italy it should be in the range of 0.5%-0.6% of GDP. It is also expected that an additional fiscal stimulus of about 0.6% of GDP, at a EU level, will come through the credit supply facilities of the European Investment Bank.

Budget deficits are, however, going to rise significantly. Most of the above mentioned fiscal measures are included in the baseline scenario used in this note. The effects of these measures should be felt already during 2009, as spending plans affect more directly consumption decisions and living standards than monetary policy measures. If timely implemented, fiscal expansions could provide an effective contribution to avoid a more prolonged recession in most countries. They are, however, also going to have negative repercussions in the budgets of most economies. Both as a result of lower growth and higher net government expenditure fiscal balances are expected to deteriorate in the medium term. The fiscal deficit-to-GDP ratio for the United States, Japan, and the UK is projected to be above 7% in 2010; more than three times higher than the 2008 level in the latter. Germany's fiscal deficit is projected to worsen by 2.7 percentage points of GDP to 3%, whereas Italy's and France's deficits are projected at about 4%.

In emerging markets fiscal policy will be the dominant response to the crisis. Monetary policy instruments and markets are less developed in these countries and inflation pressure more significant, thereby limiting the use of

monetary policy to provide counter-cyclical support to the economy. Among BRIC countries, Russia will see its significant budget surplus disappear over the next two years, China's positive fiscal balance will turn into a deficit, while India will keep its (already high) fiscal deficit relatively stable. Over the medium term fiscal deficits are expected to remain high in most emerging countries, with potential consequences for productivity and inflation: the new public enemies of the post-crisis environment.

A marked worsening in government budget deficits

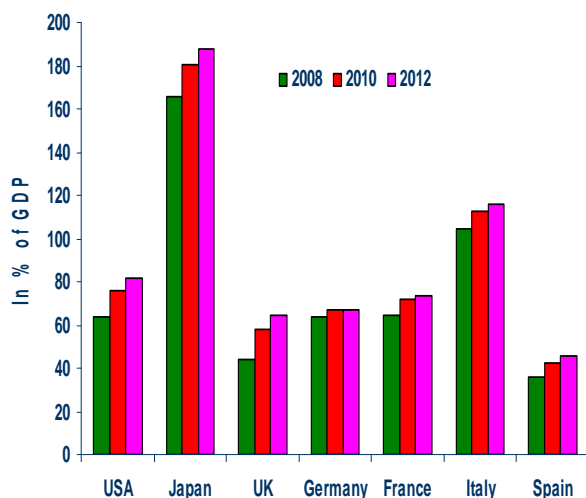


Source: Oxford Economics

Public debt incidence will also increase. Under the fiscal policy assumptions of the Oxford Economics scenario, this will result in a sharp rise in the public debt-to-GDP ratio through 2012 in the industrial economies. Such a ratio should go up by about 20 percentage points of GDP for the United States and Japan, about 10 percentage points for France, Italy, Spain and the UK and 5 percentage points for Germany. The effects of the accumulation of new public debt will vary depending on the degree of indebtedness of each country. Countries with higher initial levels of debt are more likely to pay higher spreads and incur in more refinancing difficulties. For emerg-

ing markets consequences may be even worse as public debt levels that give rise to sustainability concerns tend to be much lower than in advanced economies (on average 30-40% of GDP in former as opposed to 60-80% of GDP in the latter).

Higher budget deficits mean more public debt



SACE calculations on Oxford Economics data.

The quality – not only the quantity – of the fiscal stimulus matters. Fiscal measures should be timely, temporary, and well targeted. In general, an increase in public expenditure is more suited than a reduction in taxation for the purpose of stemming a recession as fiscal multipliers tend to be higher for spending measures. However, the behavioral impacts of fiscal measures should also be considered: while more government spending can translate into higher consumption ability, households may rationally infer that more taxes will be needed in the future to close the government budget gap. This may reduce their permanent income and therefore current consumption. On the other hand, while tax cuts are less effective to promote a consumption boost than expenditure measures, lower taxes may reduce distortions.

The composition of fiscal expansions is also key. Not all types of government expenditures are alike in terms of their economic impact. Many countries are acting through a boost in infrastructure spending, which could not be timely enough if not directed to major projects already planned. The IMF suggests to choose “stimulus measures that are large and diversified and that will last longer than one-two quarters”. Measures should be aimed at highly-impacted sectors and low-income households through unemployment subsidies, specific benefits for basic needs, and greater tax benefits. Tax reductions would help more if cuts were focused on personal income and sales tax. More importantly, discipline will have to be quickly restored as the global economy exits the crisis. Preventing the build-up of structural imbalances and over-regulation, which could set the stage for the next crisis, is the real challenge.



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