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An ABC of financial shocks and fiscal aftershocks

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"Is the crisis over, Daddy?"

"Not really, Bobby. Just look at the news of market turmoil."

"Why isn't it over, Daddy?"

"The **crisis began in August 2007** and reached its worst in autumn of 2008. By historical standards, that is not so long for such a big crisis."

"Not so long, Daddy? Did you not say that the guarantees and capital injections, the money-printing by central banks – 'unconventional policy', you called it – and the borrowing by governments had fixed the crisis?"

"Bobby, you don't pay enough attention," replied his father, a bit impatiently. "What I said is that these actions would stop the crisis from becoming a depression. I was right, as usual."

Bobby smiled, affectionately.

"Stop smirking," said his father. "Take the rich western countries: their output shrank by 3.3 per cent last year – the worst performance since the second world war. You do know about the war, don't you?"

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"Oh yes. We have studied it at least three times at school."

"Well, the Organisation for Economic Co-operation and Development – I know, that's a mouthful – said this week that the output of the rich countries **might grow by 2.7 per cent this year**. The world economy is forecast to grow 4.6 per cent after a 0.9 per cent decline in 2009. This is better than almost anybody expected even half a year ago."

"If that's true," replied the boy, "why do all these people talk about 'instability'? What's that about?"

"You know about aftershocks following earthquakes. Well, fiscal crises can be the aftershocks of financial crises. And then they can cause financial aftershocks, in their turn."

Bobby was beginning to find this lecture interesting, to his surprise. "So how does that work, Daddy?"

"Well, think about what happened before the financial earthquake of 2007-09: there were huge rises in property prices and booms in construction; there was an explosion of private debt; and there was a big increase in financial complexity. So, when property prices fell, we had the big panic. But two other things happened: governments received more revenue than they had expected, most of which they spent; and they borrowed easily, too.

"In the new eurozone, all governments found they could borrow as if they were Germany's. Households and businesses could also borrow on German terms. So they bought and built. In the good times, wages also soared."

Bobby yawned. His father drove on.

"So what happened after the crisis? Fiscal deficits exploded to levels never before seen in peacetime, particularly in countries affected by the bubbles – the US, UK, Ireland and Spain. So the threat of a fiscal crisis emerged.

“What triggered this aftershock was the revelation that **Greece** had lied about its fiscal position, followed by the inability of the eurozone to respond: Germans were outraged at the idea that they should rescue irresponsible profligates; others thought the Germans inflexible bullies. So the Europeans made the same mistake as the Americans had made when responding to financial worries: they let the crisis get ahead of them.”

“But they **bailed out Greece**,” said the boy. “So why all the turbulence?”

“The big point is that investors are not altogether stupid: they know these are temporary patches; they know Greek indebtedness is going to worsen; they know that other countries in peripheral Europe will find it hard to grow out of their plight; they know that solidarity among eurozone member countries is fraying; they know **Germans are very angry**; and they know that inadequately capitalised banks are vulnerable to sovereign risks. All this makes the **euro** seem a worse bet. So it has fallen in value.”

“I understand that,” replied Bobby. “But won’t that help the eurozone?”

“Yes,” agreed his father. “But it will worsen prospects elsewhere – in the UK and US, for example. And then there’s the worry that these countries have huge fiscal difficulties, too. The markets don’t seem to mind now. But they might change their view. Worse, they don’t know what to fear: will it end up in deflation, default, inflation, financial shocks, or all of these? Markets are unpredictable, like children.”

Bobby decided not to respond to this teasing. “So,” he asked thoughtfully, “what’s going to happen next?”

“If I knew that, I wouldn’t be a mere economic journalist,” his father said.

Bobby smiled: a familiar remark.

His father did not notice. “Maybe, the momentum gained by the US and the big emerging markets, especially China, will let the world ride through the shocks. The OECD calls the outlook ‘moderately encouraging’.

“Alternatively, you could argue that the massive fiscal deficits are unsustainable and that attempts to rein them in, in the eurozone and UK, are going to cause renewed recession and political strife. We have also barely begun reducing private debts, which will take years. The banks are far too big and have too many doubtful assets on their books. Meanwhile, emerging countries are too small and weak to be locomotives for the world. Some people worry that **China is overheating** or suffering from **huge asset price bubbles**, too, though I disagree. And then there is geopolitical uncertainty over **North Korea** and **Iran**. In short, markets are volatile because of all the uncertainty out there.”

Bobby was beginning to find this familiar: his father tended to see the gloomy side. But he could be wrong, as his mother enjoyed pointing out.

“Anyway,” concluded his father, “these aftershocks are likely to go on for years, with fiscal worries undermining confidence in the financial sector and back again. It will affect you, too: western governments are going to be short of money for decades. It’s going to be miserable. But you can learn Chinese and go east.”

Bobby groaned. It sounded like hard work. But he went off quietly to bed. What nightmares disturbed him?

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