FT.com FINANCIAL TIMES
COLUMNISTS
Martin Wolf
Close

After the storm comes a hard climb

Print

By Martin Wolf
Published: July 14 2009 20:21 | Last updated: July 14 2009 20:21

Is the world economy on its way out of the crisis? Has the world been learning the right lessons? The answer to both questions is: up to a point. We have done some of the right things and learnt some of the right lessons. But we have neither done enough nor learnt enough. Recovery will be slow and painful, with substantial danger of relapses.

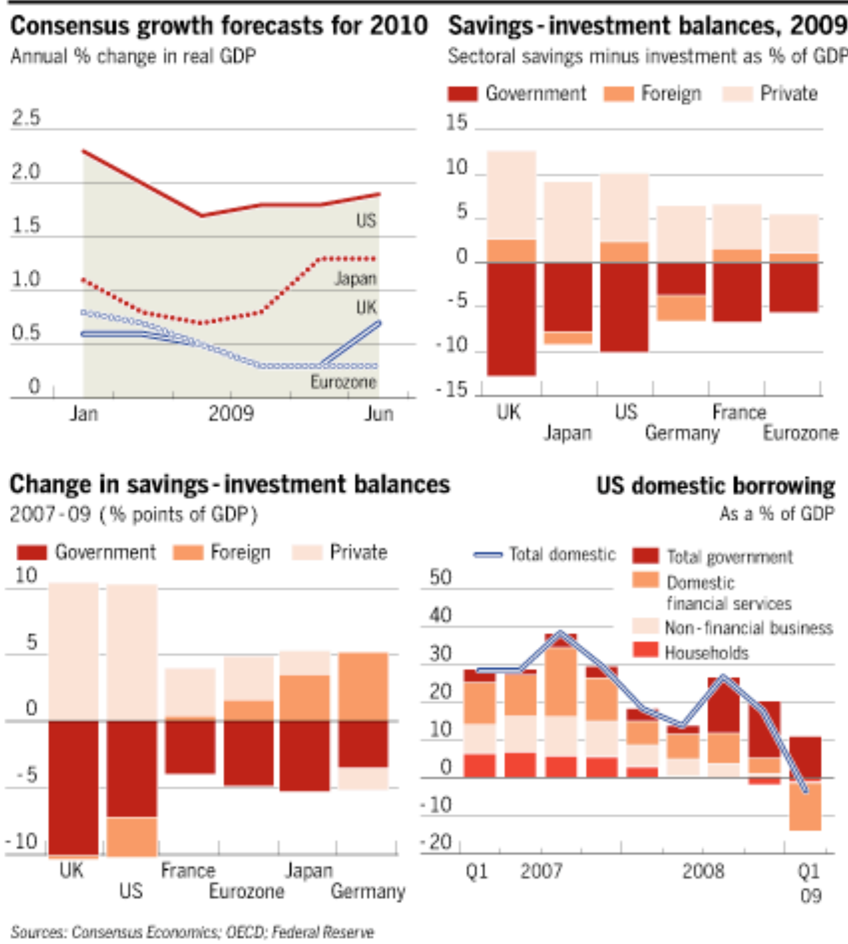
Start, however, with the good news. The financial crisis, narrowly defined, is over: stock markets have **rallied**; liquidity is returning to markets; **banks** have been able to raise equity; and the extreme risk spreads in financial markets of last year have disappeared. When addressed powerfully, panics end. In this case, the commitment of the authorities to the rescue of a failing financial system was unprecedented. It has had the desired results.

The worst of the economic crisis is also passing. As the Organisation for Economic Co-operation and Development noted in its latest **Economic Outlook**, "for the first time since June 2007, the projections ... have been revised up for the OECD area as a whole compared with the previous issue". Similarly, the **International Monetary Fund** states in its latest **World Economic Outlook update** that "economic growth during 2009-10 is now projected to be about half a percentage point higher than forecast by the IMF in April, reaching 2.5 per cent in 2010".

Such a turning point in forecasts is an indicator of pending recovery. It emerges clearly in the successive monthly consensus of forecasts for 2010. Improvements in these forecasts can be seen for the US, Japan and the UK, though, worryingly, not for the eurozone (see chart). China's forecasts show great resilience. Confidence in India is also rising.

Yet we must put this news, welcome though it is, in context. The worst of the financial crisis may be behind us, but the financial system remains undercapitalised and weighed down with an as yet unknown burden of doubtful assets. It is also far from a truly "private" financial system. On the contrary, it is underpinned by massive explicit and implicit taxpayer support. The probability of mischief down the road is close to 100 per cent. But the current hope is that the road to any such mischief goes via a recovery.

Equally, the expected economic "recovery" is not going to feel like much of one. The latest consensus forecasts for growth in the high-income countries for 2010 are well below potential. Yet this is also at a time when the admittedly uncertain estimates of "output gaps" (or excess capacity) are at extreme levels. For 2009 the OECD estimates these at 4.9 per cent of potential gross domestic product in the US, 5.4 per cent in the UK, 5.5 per cent in the eurozone and 6.1 per cent in Japan. Given the forecasts for modest growth, excess capacity will be greater at the end of 2010 than at the end of 2009. The risks to inflation – or rather risks of deflation – are self-evident. So are the chances of further jumps in unemployment. In keeping with this, the "breakeven rate" of inflation implied by inflation-indexed and conventional US treasury bonds has fallen again, to close to 1.5 per cent. June's hysteria over rising yields on conventional bonds looks absurd.



Behind the excess capacity and the massive increases in fiscal deficits is the disappearance of the high-spending consumer, above all from the US. This is suggested by the huge shifts in the balance between private sector incomes and spending implied by OECD forecasts for current account and fiscal balances. In 2007, the US private sector spent 2.4 per cent of GDP more than income. In 2009, suggests the OECD, it will be spending 7.9 per cent of GDP less than income. This massive shift into prudence – long called for by critics and so little appreciated now it has come – largely explains the shift into fiscal deficits: between 2007 and 2009, a 10.3 per cent of GDP shift in the private sector's balance between income and spending was offset by a 7.3 per cent of GDP fiscal worsening and a 3 per cent of GDP improvement in the current account deficit (see chart). Even as it is, this fiscal offset has not prevented a deep recession.

Private sector prudence is likely to endure in a post-bubble world characterised by mountains of debt. In the last quarter of 2008 and the first quarter of 2009, US household borrowing was modestly negative. But at the end of the first quarter of 2009 the ratio of gross household debt to GDP was a mere 2 per cent of GDP lower than at the end of 2007. De-leveraging is a painful process: it has barely begun.

If, as is likely, the private sector remains prudent, the public sector will remain profligate. Moreover, so long as this period of retrenchment lasts, the risk will not be inflation, but rather deflation. The lesson from **Japan** is that fiscal profligacy and deflationary pressure can last longer than anybody imagines. The longer they last, the trickier and more inflationary the exit may prove.

Those who expect a swift return to the business-as-usual of 2006 are fantasists. A slow and difficult recovery, dominated by de-leveraging and deflationary risks, is the most likely prospect. Fiscal deficits will remain huge for years. The alternatives – liquidation of excess debt via either a burst of inflation or mass bankruptcy – will not be permitted. The persistently high unemployment and low growth may even threaten globalisation itself.

Depending heavily on massive monetary expansion and fiscal deficits in erstwhile high-spending countries will ultimately be unsustainable. As I have argued, the stronger is the growth in demand in erstwhile

surplus countries, relative to potential GDP, and so the more powerful is global rebalancing, the healthier will be the global recovery. Is this going to happen? I doubt it.

If the exit into vigorous recovery seems still so uncertain, has the world at least been learning the right lessons for future management of the world economy? I believe not. The financial sector that is emerging from the crisis is even more riddled with moral hazard than the one that went into it. Its fundamental weaknesses are not yet redressed. Questions also remain about the working of the dollar-based international monetary system, the right targets for monetary policy, the management of global capital flows, the vulnerability of emerging economies, demonstrated in central and eastern Europe, and, not least, the financial fragility demonstrated so often and so painfully over the past three decades. However difficult the recovery may be, we must not ignore these questions. After my summer break, I look forward to addressing them in September.

martin.wolf@ft.com
More columns at **www.ft.com/martinwolf**

Copyright The Financial Times Limited 2009

"FT" and "Financial Times" are trademarks of the Financial Times. Privacy policy | Terms
© Copyright The Financial Times Ltd 2009.