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Why the 'green shoots' of recovery could yet wither

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Published: April 21 2009 20:24 | Last updated: April 21 2009 20:24

Spring has arrived and policymakers see "green shoots". Barack Obama's economic adviser, Lawrence Summers, says the **"sense of freefall"** in the US economy should end in a few months. The president himself spies **"glimmers of hope"**. Ben Bernanke, chairman of the Federal Reserve, said last week **"recently we have seen tentative signs that the sharp decline in economic activity may be slowing, for example, in data on home sales, homebuilding and consumer spending, including sales of new motor vehicles".**

Is the worst behind us? In a word, No. The rate of economic decline is decelerating. But it is too soon even to be sure of a turnround, let alone of a return to rapid growth. Yet more remote is elimination of excess capacity. Most remote of all is an end to deleveraging. Complacency is perilous. These are still early days.

As the Organisation for Economic Co-operation and Development noted in its recent **Interim Economic Outlook**, "the world economy is in the midst of its deepest and most synchronised recession in our lifetimes, caused by a global financial crisis and deepened by a collapse in world trade". In the OECD area as a whole, output is forecast to contract by 4.3 per cent this year and 0.1 per cent in 2010, with unemployment rising to 9.9 per cent of the labour force next year. By the end of 2010, the "output gap" – a measure of excess capacity – is forecast to be 8 per cent, twice as large as in the recession of the early 1980s.

In the US, the rate of decline of manufactured output compares with that of the Great Depression. Japan's output of manufactures has already fallen by almost as much as in the US during the 1930s (see chart). The disintegration of the financial system is, arguably, worse than it was then.

If the world experiences a "Great Recession", rather than a Great Depression, the scale of policy support will be the explanation. Three of the world's most important central banks – the Federal Reserve, the Bank of Japan and the Bank of England – have official rates close to zero and have adopted unconventional policies. The real OECD-wide fiscal deficit is forecast at 8.7 per cent of gross domestic product next year, with a structural deficit of 5.2 per cent. In the US, the corresponding figures are 11.9 and 8.2 per cent. Governments of wealthy countries have also put their healthy credit ratings at the disposal of their misbehaving financial systems in the most far-reaching socialisation of market risk in world history.

It would be impossible for such activism to have had no effect. We can indeed see partial normalisation of financial markets, with a marked reduction in spreads between riskier and less risky assets (see charts). The FTSE All-World index has jumped by 24 per cent and the S&P 500 by 23 per cent since March 9 2009. Purchasing managers' indices are picking up (see chart). More broadly, the chances of a manufacturing turnround are high: big falls in demand generate inventory build-ups and collapses in output. The latter are sure to reverse. China's growth is also rebounding.

We can say with some confidence that the financial system is stabilising and the rate of decline in demand is slowing. But this global recession is different from any other since the second world war. Its salient characteristic is uncertainty.

Consider obvious perils: given huge excess capacity, a risk of deflation remains, with potentially dire results for overindebted borrowers; given the rising unemployment and huge losses in wealth, indebted households in low-saving countries may raise their savings rates to exceptional levels; given the collapse in demand and profits, cutbacks in investment may be exceptionally prolonged and severe; given massive and persistent fiscal deficits and soaring debt, risk aversion may lead to higher interest rates on government borrowing; and given the flight from riskier borrowers, a number of emerging economies may find themselves in a vicious downward spiral of weakening capital inflow, falling output and reductions in the quality of assets.

In short, as Stephen King and Stuart Green of HSBC note in a recent report, the exceptional dynamics of this crisis suggest a healthy scepticism about the timing and speed of recovery. What is most disturbing, moreover, is the scale of the policy action required to halt this downward spiral. This raises the big question: how and when might the world return to normality, with sustainable fiscal positions, strongly positive short-term official interest rates and solvent financial systems? That Japan has failed to achieve this over 20 years is surely frightening.

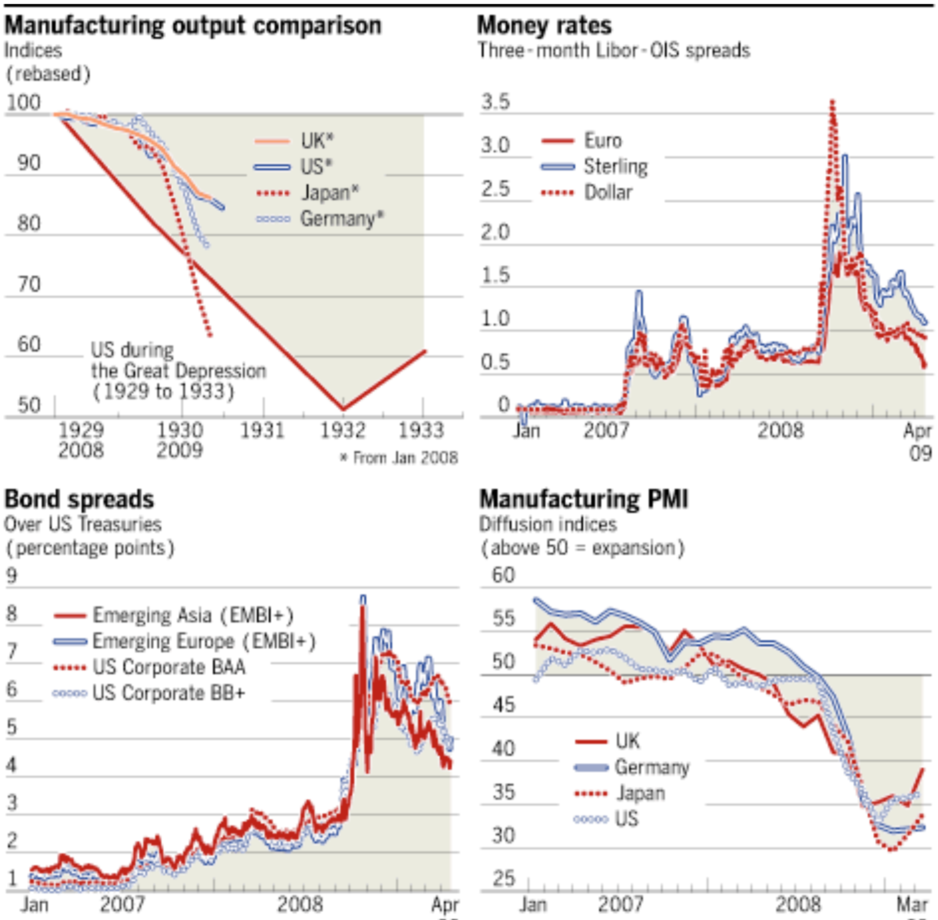
What I find most disturbing of all is the reluctance to admit the nature of the challenge. In its policy advice, even the OECD seems to believe this is largely a financial crisis and one that may be overcome in quite short order. Even the latter looks ever more implausible: in its latest **Global Financial Stability Report**, the International Monetary Fund now estimates overall losses in the financial sector at $4,100bn (€3,200bn, £2,800bn). The next estimate will presumably be higher.

Above all, the financial crisis is itself a symptom of a balance-sheet disorder. That, in turn, is partly the consequence of structural current account imbalances. Thus, neither short-term macroeconomic stimulus nor restructuring of balance sheets of financial institutions will generate sustained and healthy global growth.

Consider the salient example of the US, on whose final demand so much has for so long depended. Total private sector debt rose from 112 per cent of GDP in 1976 to 295 per cent at the end of 2008. Financial sector debt alone jumped from 16 per cent to 121 per cent of GDP over this period. How much of a reduction in these measures of leverage occurred in the crisis year of 2008? None. On the contrary, leverage rose still further.

The danger is that a turnround, however shallow, will convince the world things are soon going to be the way they were before. They will not be. It will merely show that collapse does not last for ever once substantial stimulus is applied. The brutal truth is that the financial system is still far from healthy, the deleveraging of the private sectors of highly indebted countries has not begun, the needed rebalancing of global demand has barely even started and, for all these reasons, a return to sustained, private-sector-led growth probably remains a long way in the future.

The world economy cannot go back to where it was before the crisis, because that was demonstrably unsustainable. It is at the early stages of a long and painful deleveraging and restructuring. Fortunately, policymakers have eliminated the worst possible outcomes. But there is much more yet to be done before fragile shoots become healthy plants.



Source: Thomson Reuters Datastream

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