

A macroeconomic perspective of the Western economy and the financial crisis

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A crisis and a recession does not appear of a sudden: the keys to each stage of the economic cycle are to be found in previous periods. This proved to be true once again in the 2007 financial crisis. The purpose of this article is to show how a long period of macroeconomic stability, high growth and low interest rates created the real estate bubble that is at the origin of the crisis. How did that period of permissive monetary policies, cheap money, real estate speculation and optimism come about? Is the crisis the inevitable result of previous developments? And will such circumstances appear again once the recession is over?



Introduction¹

Neither a crisis nor a recession appears of a sudden. The key to each stage of an economic cycle is to be found in previous periods: it is excess during expansion what renders recession inevitable. This proved to be true once again in the 2007 financial crisis: a long period of macroeconomic stability, high growth and low interest rates created the real estate bubble and allowed financial errors that eventually led to a deep crisis.

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This article intends to describe the evolution of the global economy during the first years of the 21st century in order to understand how the financial crisis and recession came about.

By financial crisis we mean the situation in which survival of a large number of financial institutions is in jeopardy to the point that it may even paralyse the functioning of the whole financial system. Recession is characterised by considerable deterioration of variables such as production, employment and investment; it can be a consequence of financial crisis but also the effect of other causes.

We will basically focus on the economy of the United States, as what has occurred in recent years cannot be understood unless we have a look at it. However, we will also take a glimpse at other countries as they appear in our analysis. First we will explain the bullish years that created the conditions that turned the crisis possible (or inevitable?). We are not going to explain the financial crisis or the recession in detail, nor action taken by governments and central banks to counteract it, which other articles in this *Paradigmes* issue deal with; instead, assuming that the reader is knowledgeable, we will do an exercise of

«economy-fiction» to try to explain in what setting the world economy will find itself after the crisis and, more specifically, if the situation that led to it can occur again.

The setting prior to the financial crisis

The years that followed the oil crises in the 1970s and adjustment in the early 1980s were of «big moderation»: a period of long expansion, smooth recession and low inflation – though other variables, such as current account, public debt and exchange rate were less moderate. There were also some crises like the 1987 stock exchange crash, the Japan crisis in the 1990s, troubles in the European Monetary System (1992-93), Mexico (1994), the Asian crisis (1997), that in Brazil and Russia (1998), in Argentina and the burst of the dotcom bubble (2001), but generally speaking, economic performance was good. The whole of OECD countries grew at an annual 3% between 1984 and 2006.

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This long time of expansion can be attributed to the absence of considerable difficulties (e.g. oil prices) and especially to low interest rates that lasted for years, basically out of two reasons: 1) considerable savings rates all over the world, not only in traditionally austere countries like Japan or Germany, but also in emerging ones, with China and the oil producing countries at the forefront, and 2) the expansive monetary policy of the US. However, this needs to be further explained, as it is probably the ultimate cause for the current crisis.

Periods of high growth and abundant liquidity often end up in increasing inflation. This did not occur in years of «big moderation», as labour costs were held back: since the 1980s, billions of people had been entering the world market after being kept off by isolation in communist countries or restrictive policies in Asian and Latin American ones. This moderate inflation (2.4% in the US and 1.9% in the euro-zone in 1995-2007) explains why central banks did not raise interest rates, which prolonged economic expansion.

However, this was also the ideal setting to create bubbles, i.e. price growth of a given asset fundamental variables do not justify. Towards the end of the 1990s the dotcom bubble grew before bursting in 2000 and causing a recession. But the Federal Reserve had the recipe to get out of it as soon as possible: a quick reduction of interest rates. And so it did: interest rates of federal funds, those used by the Fed to control monetary policy, fell from 6.5% to 1.75% within one year.

Low interest rates encouraged families to leverage, as well as consumption and housing demand, thus consolidating recovery. But the Federal Reserve went on lowering nominal interest rates down to 1.0% in June 2003, keeping real rates negative till late 2005, when it raised doubts on the strength of recovery and fears of deflation. The expansion phase of the cycle thus became euphoria. A global bubble in the real estate market grew: between 1997 and 2007, housing prices soared a 401% in South Africa, 220% in Ireland, 195% in Spain, 174% in Australia, 150% in France and Sweden and more than 100% in the United States.

This anomalous policy was reproduced in other countries: the European Central Bank also kept its interest rates at an excessive low level, perhaps out of fear that a more restrictive policy could strengthen the euro too much as it was already appreciating, and Japan went on maintaining interest rates between 0 and 0.5% in those years.

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More expenditure and less savings led to considerable current account debt (the average balance between 2002 and 2007 was 5.4% as of GDP in the US, 5.4% in Australia, 5.8% in Spain and even higher rates in New Zealand, Hungary, Portugal and Greece, topped by Iceland with 11.6%) and abundant resort to foreign funding, which in the case of the United States came especially from oil producing countries and China, which avoided appreciation of its currency by buying dollars massively. This external imbalance was the other side of growth of consumption, building and investment in owing countries. Low interest rates in the United States also explain massive depreciation of the dollar (above 65% against the euro between 2001 and 2007).

An unexpected effect of cheap money was the move of demand of profitable assets towards commodity markets. Oil climbed from \$20 a barrel in 1998 to \$147 one decade later, and mineral prices grew by 230% within the same period. The cause of this development was considerable growth in global demand, led by China and India and supported by other countries, both emerging and advanced, but it was also due to insufficient offer, the reasons of which were manifold: low oil prices in the 1980s had discouraged from prospecting and opening new fields; prospect and exploitation costs had increased due to technical or environmental reasons; and finally, most of this investment had to be done by public companies from producing countries that were a considerable source of income to their governments but did not play a relevant role in their priorities regarding expenditure. So all these effects were completed by diversion of financial resources to investment in raw materials, looking for that profitability investors did not get from elsewhere. This had also an influence in the oil

price (as well as in that of other raw materials) through Saudi Arabia's price fixing policy.

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Expansion eventually became generalised: intensive economic activity drove exports from and the GDP of emerging countries, which also benefited from the entry of capital as a result of low interest rates and the lowering of their risk premium thanks to strict policies carried out since the crises in the previous decade.

The other main component of the pre-crisis setting is financial innovations. Apart from abundant liquidity and low interest rates, new opportunities triggering a price growth of a given asset are needed to create a bubble, and this usually occurs through some financial innovation. In the period we are dealing with, it was the hype of **subprime mortgages** in the United States, securitisation and the development of a «shadow» financial system what allowed the bubble to grow, which aggravated the crisis once it burst. However, as we said before, let us leave for other articles this subject and all those related to the development of the crisis and action taken by governments and central banks.

The future framework

How will the macroeconomic setting be like after the current crisis and recession? Is it likely that the same conditions having led to the current situation occur again?

We economists are supposed to be able to make conditional predictions like «if A occurs (and all the rest keeps constant), B will happen». The problem is that we do not know

what A is, because governments and central banks take new measures when new problems come up. Besides, nothing is constant. So the most likely to occur is that under current circumstances, any attempt at projecting the future is doomed to fail. Nevertheless, we can try and give some thoughts we are going to explain now.

In early 2009, governments decided measures along two lines: first, holding down recession and fostering recovery, and second, halting the financial crisis (a third line, preparing the institutional, regulatory and legal framework of the financial system for the future is still being studied). In the first line, monetary policy is not useful under present conditions, so governments trust tax policy despite the question marks it raises on its efficacy, the delay with which its effects will be felt in production and especially the impact of massive public debt emission on interest rates and thus on financing of the private sector.

The near future – maybe the next three years – will depend on the evolution of the recession and the effectiveness of governmental measures. Beyond this timeframe, the global macroeconomic setting we are dealing with will depend on several factors:

- ▶ Will a setting with low interest rates occur again? In the short term, the answer seems to be yes, given the formidable creation of global liquidity by central banks. But this liquidity remains in the balance of the banks, where it carries out a mission of caution and will become unnecessary once the markets recover. The key will then lie in the capacity and will of central banks to withdraw it in good time. Technically, they should not have any problem to do it, but the delay, doubts on recovery and pressure on behalf of less dynamic institutions and industries may cause a relapse into a situation of too low interest rates in the short term, or more probably to accelerated inflation once the recovery consolidates – although central banks are supposed to have learned the consequences of a too permissive monetary policy

for too long time – meaning higher interest rates in the long term.

- ▶ A quite new item in the future scenario will be growth of public expenditure and debt, which did not play a significant role before the crisis (except for the contribution to the US current account). Many governments are now sacrificing tax discipline to reach immediate recovery of aggregated demand, but the cost of these measures will be felt in the medium term. The most important will be credit becoming expensive due to growth in global demand of funding and the risk premium: once again, high interest rates in the long term.
- ▶ Are we going to see again high growth rates as in recent years? Probably not for a long time. On the demand side, consumption will moderate, at least in those countries most affected by recession such as Spain. Families will need to reduce leveraging, which will mean a stronger trend towards saving, at least for some years. If interest rates are higher, the demand of consumer credits will also be lower as already mentioned. Apathy in the real estate market will last some more years until the unsold housing stock is reduced.
- ▶ Many governments are now sacrificing tax discipline to reach immediate recovery of aggregated demand, but the cost of these measures will be felt in the medium term. The most important will be credit becoming expensive. Investment demand will also slow down due to smaller growth of consumption and higher interest rates. Regarding exports, if global growth remains low, they will not be a big driver unless the competitive capacity of the country recovers by means of cost moderation, use of its competitive advantages and innovation.
- ▶ The structure of production is on constant change. After the crisis, the real estate, the building and the finance sectors will need to come back to a more sustainable size. Whether other branches take over will depend on the structure and conditions of each country, especially on its capacity to create entrepreneurial

initiatives and its flexibility to move resources to branches with a bright future. Hence the importance of structural reform: competition, deregulation, labour market flexibility, fostering human capital and innovation, etc.

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- ▶ In the long term, a country's key to growth is its potential growth rate, which depends on two variables: labour offer (which will probably be less dynamic due to the impact of recession on migration) and its productivity, which in turn depends on variables such as physical and human capital allocations, technology and ability to innovate. Once the recession is over, many of these variables will resume their previous trend, although some significant change is likely to occur: for instance, regulation in the finance industry will increase, interest rates and risk premiums will be higher, the credit volume will not grow at the same pace as before and capital creation will thus be lower. To put it simple, the capacity to grow will probably be more moderate than in times when housing pushed the economy.
- ▶ Will global imbalance be reduced, and more specifically the gap between savings in some countries and expenditure in others? Probably yes, but to a limited extent. In countries having now a negative current account, higher family savings will be compensated by government expenditure; the result may be ambiguous. Adjustment will depend on exchange rate movements and the pace of income loss (in Spain, recession is almost the only way of adjusting the foreign balance sheet). The evolution of exchange rates is hardly foreseeable beyond likely depreciation of the dollar to attract the necessary funds for US stimulation policies and to moderate their current account debt.

▶ On the side of countries having a surplus now, the savings rate in emerging ones will be reduced by recession and probably be lower in the future if, for instance, consumption growth accelerates in China. Oil producing countries will reduce their surplus in the short term as well, though it can increase again in the longer term, as we will see further on. However, the map of fund supplying and demanding countries is likely to change. Expansive tax policies in many countries will require net capital imports, which will only be possible if their current account is negative, which in turn will contribute to higher interest rates at global scale. And if global demand of secure assets (public debt) keeps high, American current account debt is likely to be high again without posing a problem to the world economy.

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- ▶ The oil price will recover when demand also does, and then scarcity in offer will become acute, aggravated by the present period of low prices and insufficient investment in prospect and exploitation. Hence it is probable that the trend towards more expensive oil accelerates in the future.
- ▶ In recent discussions, forecasts have been made that belong to economy-fiction: for instance, dismantling of the eurozone or the possibility that some country leaves it. This is very unlikely because the cost on credibility of the own policies and on the own risk prime would be prohibitive. A different thing is that the euro countries are able to implement new policies, from liberalising their markets to single or more coordinated mechanisms of financial monitoring and regulation: dynamism in Europe will still be reduced.
- ▶ The relevance of the United States in the world economy is shrinking, and this trend is likely to continue, but not to the benefit of Europe or Japan, as their strength will not increase out of

the recession, but to that of emerging powers, especially China and India, although there are some major uncertainties about both: political sustainability, social peace and pacific transition to democracy (if it occurs) of the Chinese regime, social, economic and political imbalance in India, Russia's decline, etc.

- ▶ The 2007 financial crisis was not a crisis of capitalism despite the reactions it caused. Albeit discredited, it is still the best available option as of now. Recession is likely to stress on economic protectionism, interventionism and nationalism, but this will only hamper global growth.

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- ▶ One of the most affected branches by the 2007 crisis will be economics. It is not about returning to Keynes or not but about questioning the assumptions of our models. We do not know what new approaches will be like, but there will doubtless be important changes.

Conclusions

Few experts were able to anticipate the current recession. And this is reasonable enough: policies made up to 2007, not all too contractive, were no apparent reason for what has happened. But we did not count on a new factor: the financial crisis. The latter was foreseen by some who noticed that the growth of real estate credit was unsustainable and the balance sheet of many financial institutions was bearing new risks. But it was not at all easy, based on the problems of some countries or institutions, to predict a systemic and global crisis, at least until delinquency of high-risk mortgages started increasing in early 2007.

In this article we have discussed the macroeconomic and financial setting the global economy was moving in and its relation with the crisis. Once things have happened, it is easy to understand how low interest rates, plentiful liquidity, the creation of benefit opportunities leading to bubbles and political errors triggered first a financial crisis and then a deep recession. Nevertheless, the important issue is not to find culprits but especially to introduce necessary reform to prevent such a crisis from occurring again in the future. However, given the history of the last two centuries, the best prophecy we can make is that there will be a crisis again because man is the

only animal stumbling several times over the same stone. The most we can expect is that they take a very long time to stumble again, and that the consequences from this will be less negative than in the present crisis.

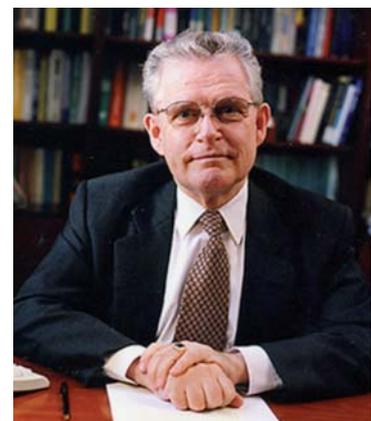
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Notes

1. This work is part of the activities at the «La Caixa» Chair of Corporate Social Responsibility and Corporate Governance at IESE.