



Major Crisis of Confidence Grips the Global Economy

Policy Brief

Economic Policy Series – October 2011

Introduction

It has been a little more than two years since the global economy emerged from recession. “Conventional wisdom holds that severe recessions are usually followed by strong recoveries. This belief goes by many names. Milton Friedman termed it the ‘plucking theory’ of business fluctuations, likening recessions to down plucks on a guitar string. The essential insight is that the harder you pluck down, the faster the string snaps back to its original position.”¹ This time around the bounceback effect—or a V-shaped recovery—is not in the cards.

The world economy has hit a rough patch on the road to recovery. One adverse event after another has roiled financial markets, zapped confidence and created an air of uncertainty. As Shakespeare wrote, “When sorrows come, they come not single spies, but in battalions.”² The world has witnessed political unrest in countries across the Middle East and North Africa (MENA), a spike in oil prices, supply chain disruptions from



- 1 Wynne, Mark A. (2011). “The Sluggish Recovery from the Great Recession: Why There Is No ‘V’ Rebound This Time.” *Economic Letter – Insights from the Federal Reserve Bank of Dallas*. Vol. 6, No. 9. Federal Reserve Bank of Dallas. September.
- 2 Shakespeare, William. (1603). “The Tragedy of Hamlet, Prince of Denmark.”

The Canadian Chamber is committed to fostering a strong, competitive and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today.

We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are not designed to recommend specific policy solutions, but to stimulate public discussion and debate about the nation’s challenges.

Economic Policy Series Sponsored by

the Japanese earthquake, the escalation of the eurozone's sovereign debt crisis, bitter political wrangling in Washington over the federal debt ceiling, and Standard & Poor's decision to downgrade U.S. government debt. Then came the rising drumbeat of weaker than expected economic data – in the second quarter, the U.S. economy grew just 1.3 per cent while Canada's economy contracted by 0.4 per cent. The recovery in the eurozone has stalled. Emerging-market economies have maintained relatively strong growth, but the battle against persistently high inflation, insufficient aggregate demand and weakness in major export markets is beginning to affect their growth as well.

Warning signs are flashing red. Christine Lagarde, Managing Director of the International Monetary Fund (IMF), said the "world is collectively suffering from a crisis of confidence."³

Animal spirits⁴ have dimmed and spontaneous optimism has faltered, holding back consumer spending, investment and job creation. There is simply a lack of confidence in the ability of governments to deal with their fiscal problems in light of the deteriorating economic outlook.

"I believe there is a path to sustained recovery, much narrower than before, and getting narrower. To navigate it, we need strong political will across the world – leadership over brinkmanship, cooperation over competition, action over reaction," Ms. Lagarde said in a speech in September.⁵

The stakes could not be higher at the November G20 summit in Cannes. Time is running out. The leading economies need to find common ground and demonstrate they are willing to take tough steps to rein in debt and achieve strong, stable and balanced global growth.

3 Lagarde, Christine. (2011). "The Challenges for the Global Economy." Opening Remarks at the Royal Institute for International Affairs. Chatham House, London. September 9.

4 Keynes, John Maynard. (1936) "The General Theory of Employment, Interest and Money." Keynes coined the term "animal spirits" to describe people's somewhat rash, emotional and impulsive actions.

5 Lagarde, Christine. (2011). "Global Economic Challenges and Global Solutions." An Address at the Woodrow Wilson Center. Washington, DC. September 15.

High Public Debts Pose a Significant Risk to the Global Economy

The G20 countries provided unprecedented – \$5 trillion – in stimulus to revive the global economy and stabilize the world’s financial system.

Many countries emerged from the recession with the highest deficit- and debt-to-GDP ratios since the Second World War. The IMF⁶ estimates the average deficit among advanced G20 economies reached an estimated 7.4 per cent of GDP in 2011, well above the pre-crisis (2007) level of 1.8 per cent.

Government gross debt is projected to hit 109.5 per cent of GDP, on average among advanced G20 countries, substantially higher than the pre-crisis level of 78.1 per cent. In the U.S., government debt ballooned from 62.3 per cent of GDP in 2007 to an estimated 100.0 per cent in 2011. Canada is in a relatively better fiscal position compared to most industrialized countries – gross debt increased from 66.5 per cent of GDP in 2007 to an anticipated 84.1 per cent in 2011.

We have all heard about the high levels of public debt in Greece (165.6 per cent of GDP), Italy (121.1 per cent), Portugal (106.0 per cent) and Ireland (109.3 per cent).



As we have seen, spiraling public debt can become a major threat to global financial stability. “Recent developments in Spain and Italy demonstrate how swiftly and severely market confidence can weaken and how even large advanced economies are exposed to changes in market sentiment.”⁷

“We are not without options. We know what needs to be done to support growth, reduce debt, and prevent further financial crisis. But we need a new approach – based on bold political action, with a comprehensive plan across all policy levers, implemented in a coordinated global way.”⁸

⁶ International Monetary Fund. (2011). “Addressing Fiscal Challenges to Reduce Economic Risks.” *Fiscal Monitor*.

⁷ Ibid.

⁸ Lagarde, Christine. (2011). “Global Risks are Rising, But There Is a Path to Recovery.” Remarks at Jackson Hole, Wyoming. August 27.

The Eurozone Debt Crisis Deepens

In July, eurozone leaders agreed to a fresh bailout plan (financed by the EU and the IMF) for Greece – its second – in exchange for a series of fiscal austerity measures and structural reforms to stabilize the country's public finances. They also took steps to enable Greece, Ireland and Portugal (the three countries in bailout programs) to borrow at lower interest rates on rescue loans and to repay their loans over a longer period (minimum of 15 years and up to 30 years).

These pledges of support provided some breathing room to resolve the crisis, but investors took fright. Concerns that a debt crisis cannot be fully contained sent Italy's and Spain's market borrowing costs to euro-era highs in early August. To diffuse tensions, the European Central Bank (ECB) intervened, buying Italian and Spanish sovereign bonds in the secondary market to keep yields at reasonable levels and prevent a financial meltdown. In exchange, the ECB demanded that Italy and Spain implement a series of fiscal and structural policy reforms.

As of mid-September, the ECB had about €145 billion of Irish, Greek, Portuguese, Spanish and Italian government debt on its books. The role of the ECB as a buyer of last resort to the lending system has not been without controversy. It led to the resignation of the European Central Bank's de facto chief economist Jürgen Stark (a member of the executive board of the ECB) and has raised concerns that the central bank has lost a large portion of its independence.

Meanwhile, the recession in Greece is deepening and deficit reduction is not proceeding fast enough. Many of the fiscal and structural reforms agreed upon under the terms of the bailout program are proving difficult to implement. Growing civil unrest and labour strikes have paralyzed the nation's economy. Many market participants believe that Greece will default; it is just a matter of time. This, in turn, has fuelled worries that restructuring of Greek government debt could generate significant losses for European banks.

“There are deepening concerns about the stability of European banks, whose holdings of sovereign debt issued by the most fiscally fragile of eurozone governments – Greece, Portugal, Ireland and possibly even Spain and Italy – look frighteningly large, given their relatively thin capital cushions. Those fears have fed on themselves as lenders to the banks – U.S. money market funds in particular – withdraw their short-term loans”⁹ fearing they may suffer losses if European banks fail to meet their obligations if countries default. Additionally, banks across the region have been unable to sell long-term unsecured bonds since early July. European banks have increasingly turned to the ECB for financing.

At the July 21, 2011 eurozone summit in Brussels, European leaders approved an expanded mandate for the €440-billion European Financial Stability Facility (EFSF) to enable the rescue fund to buy sovereign bonds of heavily indebted

⁹ Cohen, Norma. (2011). “Markets: Optimistic investors in short supply as volatility continues.” *Financial Times*. September 22. Fitch Ratings reported that in August, the biggest U.S. funds reduced lending to European banks to the lowest level in at least five years as the region's sovereign debt crisis intensified.

eurozone nations in the secondary market and recapitalize weak banks.¹⁰ This is considered an important step in solving the region's financial crisis. However, there is concern that the EFSF does not have enough firepower. "The fund may not be big enough to do a job that involves backing such major countries as Italy and Spain and boosting capital levels in the region's financial system."¹¹ Markets have speculated that at least €2.0 trillion will be needed to give the fund credibility.¹²

Europe's policymakers appear to be focusing on the right priorities: building a firewall around illiquid, but solvent, countries like Italy and Spain, bolstering Europe's banks and dealing more decisively with Greece.¹³ They hope to have a plan in place by the G20 Cannes summit in early November. However, there is vehement disagreement among European leaders on what needs to be done. Germany, for example, believes the main problem is fiscal profligacy – excessive state spending – and fiscal austerity is the solution. Germany is, therefore, reluctant to boost the eurozone rescue fund's firepower. A great deal of political courage will be needed to deal with the most pressing issues like restructuring Greece's debt and recapitalizing

banks.

For many of Europe's political leaders, "the choice appears to be between losing the next election by taking bold actions that are highly unpopular with the public or losing the next election because a failure to take such actions leads to a breakdown of the eurozone and a vicious recession. Faced with a choice of being hung or electrocuted, the leaders naturally search for another option, which consists of taking strong enough action to postpone the climax of the crisis while avoiding crossing the public mood so thoroughly that electoral defeat is guaranteed."¹⁴

The IMF's managing director summed it well. In Europe "we need urgent and decisive action to remove the cloud of uncertainty hanging over banks and sovereigns. Banks need urgent recapitalization. They must be strong enough to withstand the risks of sovereigns and weak growth. This is key to cutting the chains of contagion. Europe needs a common vision for its future. The current economic turmoil has exposed some serious flaws in the architecture of the eurozone, flaws that threaten the sustainability of the entire project."¹⁵

10 The EFSF was established in May 2010. The EFSF's original mandate was to safeguard financial stability in the eurozone by raising funds in capital markets to finance loans to euro area member states. The EFSF has so far been used to provide emergency loans to Portugal and Ireland.

11 Schneider, Howard. (2011). "Europe moves toward bailout fund – knowing the real debate is to come." *The Washington Post*. September 29. The beefing up of the EFSF can allow the European Central Bank to withdraw from the task of buying distressed eurozone debt and concentrate again on its key function of steering monetary policy.

12 Russell, Jonathan. (2011). "The €2 trillion fund to save the euro." *The Telegraph*. September 25.

13 The Economist. (2011). "Be afraid. Unless politicians act more boldly, the world economy will keep heading towards a black hole." October 1.

14 Elliott, Douglas J. (2011). "Why Can't Europe Get it Right the First Time... or the Second... or the Third?" Washington: The Brookings Institution. August 22.

15 Lagarde, Christine. (2011). "Global Risks are Rising, But There Is a Path to Recovery." Remarks at Jackson Hole, Wyoming. August 27.

America's Confidence is also Badly Shaken

It has been four years since the financial crisis erupted and a little more than two years since the National Bureau of Economic Research declared the end of the recession in the U.S. The recovery has been slow and erratic. To be sure, recessions that are associated with financial crises, or that are highly synchronized, have historically been followed by weak recoveries. The most recent recession was associated with both, creating a perfect storm. The recession was also unusual in that it was associated with a very deep slump in the housing market. This too has acted to slow the recovery.

The U.S. unemployment rate remains persistently high. There are 14 million Americans looking for work. The average duration of unemployment has climbed from 17 weeks in mid-2008 to 40 weeks. Beyond the headline numbers, more than eight million workers are classified as “part-time for economic reasons” because their hours had been cut back or they were unable to find a full-time job.¹⁶

Prolonged unemployment can lead to an erosion of skills. Indeed, there is a growing mismatch between the skills of the unemployed and the requirements of current job openings. Additionally, some job seekers are finding it difficult to move to where the jobs might be because they cannot sell their homes.

More than one in four homeowners have mortgages that are underwater – that is, their mortgage balance exceeds the current value of their home. With negative equity, many households cannot refinance their mortgages nor can they sell their home to pursue job opportunities elsewhere. Borrowers that are underwater, especially those out of work, are more likely to default on their mortgages and possibly face foreclosure. Two and a half million foreclosures were initiated in 2010, and a similar number is projected for 2011.¹⁷

“Nationally, house prices have been falling for six years, and most industry analysts expect further declines before prices bottom out. The collapse has left deep scars on many American families and their financial well-being.”¹⁸

It is hardly surprising that in an environment of high unemployment, a beaten-down housing market, wild swings in the stock market and meager economic growth consumers are suffering from a crisis of confidence. According to the Conference Board, consumer sentiment stagnated in September near a two-year low.

When people are uncertain about the future, they are less likely to spend. In turn, businesses will not hire or invest in plants, machinery and equipment if they are uncertain about future

¹⁶ U.S. Department of Labor. Bureau of Labor Statistics. September 2, 2011.

¹⁷ Yellen, Janet L. (2011). “Housing Market Developments and Their Effects on Low- and Moderate-Income Neighborhoods.” Remarks at the 2011 Federal Reserve Bank of Cleveland Policy Summit. Cleveland, Ohio. June 9.

¹⁸ Ibid.

demand. The economy grinds to halt while everyone waits.

Business confidence has also been undermined amid uncertainty about the direction of government policy. Businesses “cite the future of the economy itself as well as uncertainty related to employee health care cost, regulatory uncertainty, and fiscal and tax uncertainty.”¹⁹

And if things were not bad enough, the fiasco that played out in Washington over the debt ceiling and the decision by Standard and Poor’s to downgrade America’s credit rating dealt a devastating blow to public confidence adding to the country’s economic malaise.

“The country would be well served by a better process for making fiscal decisions,” said U.S. Federal Reserve Chairman, Ben Bernanke. He went on to say, “The negotiations that took place over the summer disrupted financial markets

and probably the economy as well, and similar events in the future could, over time, seriously jeopardize the willingness of investors around the world to hold U.S. financial assets or to make direct investments in job-creating U.S. businesses.”²⁰

It remains critical that U.S. policymakers clarify and implement a medium term plan to put public debt on a more sustainable path.

Jeffrey Sachs summed it up in the *Financial Times*: “A failure of economic strategy and leadership lies behind the near simultaneous collapse of market confidence in the eurozone and U.S. economies. There is no growth strategy, only the hope that scared and debt-burdened consumers will return to buying houses they don’t need and can’t afford. Sadly, these global economic currents will continue to claim jobs...until there is a revival of bold, concerted



19 Lockhart, Dennis P. (2010). “The Challenges of Monetary Policy in Today’s Economy.” Speech at the Savannah Rotary Club. Savannah, Georgia. October 18.

20 Bernanke, Ben S. (2011). “The Near- and Longer-Term Prospects for the U.S. Economy.” Speech at the Federal Reserve Bank of Kansas City Economic Symposium. Jackson Hole, Wyoming. August 26.

21 Sachs, Jeffrey. (2011). “Tripped up by globalization.” *Opinion*. Financial Times. August 18.

Canada is not Immune to Global Developments

leadership. In the meantime, the markets will gyrate in pangs of uncertainty.”²¹

In a speech to the Saint John Board of Trade, Mark Carney, Governor of the Bank of Canada, observed that “Canadians entered the summer brimming with confidence. Expecting strong sales, our businesses were full of plans to add jobs and invest in plant and equipment. Canadians themselves had a very positive view of their economic prospects. Now, in the face of alarming events abroad, some are less sure.”²²

The recent bout of negative global economic headlines and growing skepticism that policymakers will be able to stem the debt crisis and lay the foundation for a sustainable recovery are weighing on consumer and business confidence.

To be sure, Canada is vulnerable to development abroad. Slower economic momentum in the U.S. will dampen export growth.²³ Roughly 70 per cent of Canada’s merchandise exports are U.S.- bound. The direct impact of weaker European growth on Canada is relatively modest—roughly nine per cent of Canadian exports are headed for Western Europe. However, indirect effects could be significant—loss of confidence, stock market volatility as investors become less tolerant to risk, tightening of financial conditions, and falling commodity prices as global economic growth slows.

Most of Canada’s banks have limited direct

exposure to Europe. Indeed, the disclosed exposure appears to be fairly manageable against a backdrop of strong capital ratios, diversified revenue streams and relatively conservative investment practices.²⁴

To summarize, while Canada continues to enjoy relatively strong fundamentals—including resilient financial institutions, a relatively low level of government indebtedness, a triple-A credit rating and strong corporate balance sheets—a deterioration in the global economic environment will constrain growth in Canada.

But there are also opportunities. “While other industrialized nations wallow in their fiscal mud, Canada should leverage its fiscal advantage to build its competitiveness.”²⁵ It should continue to focus on four key principles that are crucial for sustained economic growth—inflation control, fiscal prudence, trade openness and structural reform. The latter includes breaking down all internal barriers to trade and labour mobility, removing work disincentives in the income-support system, eliminating burdensome regulatory procedures and minimizing tax administration and compliance costs. Policymakers should always be looking for ways to enhance the flexibility of Canada’s economy and improve its dynamism and performance so it is capable of readily adjusting and adapting to changing circumstances and economic shocks.

22 Carney, Mark. (2011). “Recent Economic Developments.” Remarks at the Saint John Board of Trade. Saint John, New Brunswick. September 20.

23 The International Monetary Fund (IMF) expects the U.S. economy to grow 1.5 per cent in 2011 and 1.8 per cent in 2012. The IMF projects growth for the 17-eurozone nations of 1.6 per cent in 2011 and 1.1 per cent in 2012. In his remarks to the Saint John Board of Trade (September 20, 2011), Bank of Canada Governor Mark Carney said “at this stage, the Bank of Canada does not expect a recession in the U.S. although the risk has clearly risen.”

24 Ho, Geoff. (2011). “Canadian Banks: Exposure to Sovereign Debt.” ScotiaMcLeod. June 8.

25 Mintz, Jack M. (2010). “Leading the Way.” *FP Comment*. Financial Post. January 27.

Conclusion

“The Cannes summit represents a critical time in the work of G20 leaders to refocus attention on their policy commitment to deliver strong, sustainable and balanced growth. Failure to do so risks plunging the world back into financial crisis and global recession.”²⁶

In light of today’s challenges, the G20 nations must honour their pledge to do all that is necessary to ensure that banks are adequately capitalized and have sufficient access to funding to deal with current risks. They must also fully implement financial reforms – including

Basel III capital measures – along the agreed timelines. It is imperative that the G20 develop and communicate clear and credible medium-term strategies to stabilize and reduce deficits while being attentive to the implications of fiscal choices for the recovery in the near term.

The financial market will continue to swoon as panicked investors take flight, and consumer and business confidence will further deteriorate until there is some resolution to the public sector debt strains that are engulfing the eurozone and the U.S. The fiscal challenges are not insurmountable. The key is for policymakers to act with conviction and urgency.



²⁶ Jenkins, Paul. (2011). “Securing Economic Recovery and Growth: The Imperative of International Policy Cooperation.” *Series: G20 at a Crossroads: Priorities for the Cannes Summit*. Waterloo, Ontario: The Centre for International Governance Innovation. September 19.

For further information, please contact:

Tina Kremmidas, Chief Economist | tkremmidas@chamber.ca | 416.868.6415 ext 222