The Global Macroeconomic Situation and Policy Implications

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August 2008 is the first anniversary of the start of the sub-prime crisis. This PREM Note provides some perspectives on the ongoing financial turmoil and the present complicated situation in the world economy. Two unifying themes can help to organize the discussion.

First, the world economy is working its way through the aftershocks of a major global credit boom-and-bust cycle. These adjustments are occurring through various channels, at different speeds, and with different lags. Different dominoes are falling at different times. The first sector to go was housing, which detonated the crisis in the financial sector, which, in turn, is pulling down the real economy. These shocks originated in the United States but are now spreading across the Organisation for Economic Co-operation and Development (OECD), notably in Europe. Slowing trade and capital flows are starting to affect developing-country growth. Efforts to ease monetary policy are complicated and weakened by the credit channel or financial decelerator mechanisms coming into play, and by the threat of a rise in inflation expectations. The crisis is described by former U.S. Treasury Secretary Lawrence Summers (2008) as “more serious than anything we have seen since the Depression.”

A second cross-cutting theme is the emergence of developing countries as major players in the world economy. This historic development is now a key source of resilience in the world economy—at present one of the few remaining—but also of new pressures and frictions. Rapid growth in key large emerging economies has been a principal driver of the surge in world commodity prices (together with earlier underinvestment and the effects of abundant global liquidity and low real interest rates). Many emerging economies are now grappling with the danger of a more sustained rise in underlying inflation, reflecting fast demand growth and the impacts of relaxed U.S. monetary policy and the falling dollar, the latter being imported into some of these economies via their exchange rate pegs to the dollar—the so-called “Bretton Woods Two” system.

The combination of these trends could, over time, undermine existing structures of international economic cooperation. Fairly or not, the present crisis will be perceived as the result of poor policy in the developed world, in particular of excessively lax monetary and financial sector supervision and regulation policies. Meanwhile, developing countries, which have improved their own policies in recent decades, can see themselves as global good citizens who are helping stem the recessionary backwash from the developed world. Given this backdrop, international forums perceived as mainly reflecting the views or interests of the developed countries could increasingly come into question or discredit. The increased reluctance of some developing economies to engage with key international financial institutions may be one indication of this trend. In this environment prevailing ideas about sound economic policy—and the economic philosophies underlying those ideas—may also come under greater scrutiny and be put more into question.

Specific Aspects of the Current Global Macroeconomic Situation

The housing bust. Housing investment is still falling in the United States and is starting to fall elsewhere. U.S. house prices are down by...
around 20 percent from their peak in mid 2006 (Figure 1). In real terms house prices are now falling in around half of OECD countries, which will contribute further to weakening in lenders’ balance sheets and reductions in consumers’ net worth. Indeed, evidence suggests that the impact of house prices on economic activity has been amplified in recent years, due to the increased use of homes as collateral for borrowing. History also suggests that housing busts take longer to clear than busts in other asset markets—about four years on average in OECD countries, about a year and a half longer than for equity market busts (IMF 2008a).

Financial turmoil is still deepening. Analysts cite several main origins for the financial crisis. There was, first, an extraordinary level of increasingly risky mortgage lending into the housing boom. Second, securitization and other financial innovations, while helping spread risk and promoting deeper capital markets, have also heightened uncertainty about ‘who owns what’ and the actual exposures of financial institutions, leading to rising credit spreads and spillovers to other asset classes. Third, analysts note the role of procyclical, active balance sheet management by leveraged financial institutions, which, when asset prices were rising, led them to rapidly expand both lending and debt, and now, when prices are falling, creates strong pressure for deleveraging (to maintain target ratios between debt levels and falling net worth) (Greenlaw and others, 2008).

Financial sector losses and write-offs are still rising. Many estimates suggest credit losses will reach around US$1 trillion, while some estimates rise to over US$1.5 trillion. Some institutions have been able to partly adjust their balance sheets by raising new capital, but, as losses mount, there are signs of investor resistance. Failing capital increases, leveraged financial institutions are under pressure to adjust balance sheets by paying down debt, reducing lending and selling assets into a falling market for that purpose. The result is an overall tightening of financial conditions despite policy efforts to ease monetary policy. Figure 2 shows that in the United States rising credit spreads, tighter lending conditions, and falling equity markets are more than offsetting the impact of monetary easing and the falling dollar.

An extended period of weak developed-country growth is widely expected. The OECD and IMF see developed-country growth slowing further, from around 1.8 percent in 2008 to 1.4–1.7 percent in 2009 (OECD 2008; IMF 2008b). Negative feedback loops are gaining ground as the adverse impact of slower growth on firm and household balance sheets feeds back into more risk aversion and tighter credit conditions. Recessions in OECD economies in the present context of a severe credit and housing contraction are likely to entail much larger output losses than normal. For OECD countries in the period 1960-2007, the cumulative output loss during a recession associated with a severe credit contraction was twice as large as in recessions without a credit crunch, while for severe housing busts it was almost two thirds larger (Claessens and others 2008).

Policy dilemmas in developed economies. Monetary policy is complicated by conflicting economic pressures. On the one hand a rise in headline inflation because of higher oil and other commodity prices is provoking concern about a possible unmooring and rise in underlying inflation expectations. On the other, there is the deflationary pressure flowing from the housing and financial sectors and the autonomous tightening of credit conditions due to rising risk aversion and deleveraging, which will likely contribute to a substantial rise in the output gap in developed countries in the next 1–2 years. Central banks have
also greatly expanded liquidity support for troubled financial institutions. In the United States the government has expanded government guarantees on the mortgage assets of Fannie Mae and Freddie Mac and regulators are also taking over failed lenders. These actions are justified by the need to maintain confidence and reduce systemic risks to the financial system as a whole. But they are also increasing concern about the burgeoning fiscal costs for taxpayers and the risk that such measures will inhibit market discipline, promote moral hazard, and foster continued excessive risk-taking by financial institutions—storing up even greater problems for future years.

**Rising inflation and fiscal pressures in developing economies.** In recent years developing economies have enjoyed their strongest and most sustained growth in several decades. Developing country imports have risen to become two thirds as large as those of OECD countries while their recent contribution to overall growth in world trade has exceeded that of the OECD by a wide margin (World Bank 2008). But developing countries are now also entering a more complicated terrain, faced with declining OECD growth and increases in both headline and core inflation. Higher world food and energy prices have a bigger impact here because of their bigger share in budgets and costs. But excessive growth in aggregate demand (relative to supply potential) is also a more significant factor than in the OECD. In many cases fast growth in domestic liquidity and aggregate demand is related to exchange rate pegs to the U.S. dollar, which result in the present relaxed U.S. monetary policy stance being inappropriately imported into fast-growing emerging economies. Some economies (including several in Europe and Central Asia) are experiencing large current account deficits that have been financed by cross-border bank lending, rendering them vulnerable to a sudden reversal in global private capital flows. Balance of payments pressures have increased more generally in oil-importing economies. Fiscal pressures are
rising in economies that have tried to shield consumers through increases in energy and food subsidies, or other fiscal means.

**Policy dilemmas in developing economies.** Although from an efficiency standpoint it is best to let higher world commodity prices feed through to domestic prices, monetary policy should be on alert to prevent a rise in underlying domestic inflation expectations (while protecting the most vulnerable social groups, for example through cash transfer schemes). A number of economies have already tightened monetary policy. The fall in the U.S. dollar has also put in question the exchange rate peg in many economies and greater flexibility is clearly appropriate in a number. However, some developing countries fear the potential for a disruptive upward surge in the exchange rate just when export markets may be slowing or entering recession. Such a shock, they fear, could temporarily stall growth in economies that are, at present, among the only remaining dynamic segments of the world economy.

**Some implications for the World Bank.** Developing countries now face the challenge of trying to maintain growth and poverty reduction while curbing inflation—all in a weakening and uncertain global economic environment. With monetary policies generally set towards greater tightening, many economies will look to fiscal policy as a way to support growth. Where such measures can be undertaken in a sustainable way and are underpinned by strong policy reforms, the World Bank can play a role through expanded development policy lending and budgetary support. Given the not always comfortable initial fiscal position of countries, the Bank should pay particular attention to helping countries improve expenditure prioritization and efficiency. In many cases there is an urgent need to move from unsustainable (and regressive) general energy and food subsidies to well-targeted modern safety-net policies. Such efficiency improvements can also free resources for longer-term infrastructure needs. Given global financial volatility, there is also a need for continued efforts to strengthen financial sector supervision and regulation, as well as continued investment climate reforms.

**About the author**

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**References**


