The Great Recession: The Next Chapter

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Outline

• The origins and impact of the Great Recession
• The eurozone crisis: additional sources of tension
• Implications for developing countries
• Changes in the global economic map
• The governance challenge
• Concluding remarks
The Great Recession: A Perfect Storm
The antecedents of the crisis in a nutshell

• Boom-bust credit boom, fueled by lax monetary policy in **developed** countries

• An asset price bubble and excess investment in real estate (poor assessment of risks)

• Poor corporate governance

• Macroeconomic imbalances
Additional considerations

• **Financial innovation and increased opaqueness**
  -- Reckless use of collateralized debt obligations
  -- Growing reliance on the originate-to-distribute business model/poorer risk assignment
  -- Derivatives increased from 2.5 times world GDP (1998) to 12 times world GDP by 2008

• **Financial integration**
  -- Much larger capital flows /cross-border positions

• **Major regulatory and supervision changes**
  -- The repeal of Glass Steagall (1999) to allow US conglomerates to leverage their balance sheets like EU universal banks; transition from Basel I to Basel II; SEC ruling on net capital (2004)...
Residential mortgage backed securities versus other securitized assets

(% GDP USA)

Source: Blundell-Wignall, Atkinson and Lee (2008), Federal Reserve, Datasteam, OECD.
Impact of the Great Recession

- A financial crisis originating in the advanced world (synchronized recession across advanced countries (2008/9) and a weak recovery in 2010/11)
- Developing countries have shown significant resilience so far, but uncertainties about recovery in industrialized countries are increasing and potential impacts via trade and financial flows (including Official Development Assistance, ODA) require close monitoring
- Increased perceptions of risk across the spectrum of trade and investment activities
  - The crisis is fostering a significant rethinking – not necessarily of the overall merits of globalization – but of how to better harness it for development ends
  - Notably, there has not yet been a significant turning away from globalization by developing countries or a significant increase in trade protectionism
- Significant changes in the roles and regulation of financial market participants
- Governments are playing a much larger role in the global economy.
- Central banks have adopted non-conventional policies (QE, LTROs...)
- Is this a “Hubble” moment for economics (Edwin Hubble and the implications of his observations supporting the concept of an expanding universe and the Big Bang theory, revolutionizing astrophysics, 1929)?
“Theory is when you understand everything, but nothing works. Practice is when everything works, but nobody understands why. At this station, theory and practice are united, so nothing works and nobody understands why.” (Source: Fisher, 2011)
The near future: a mix of good and bad news...

- Commodity prices increase has moderated and inflationary pressures are down
- Recovery of natural disasters (Japan, Thailand...) is proceeding well
- Emerging markets growth remains strong (and developing countries are expected to grow around 5.4% in 2012) and so far no signs of systemic debt problems in the developing world

BUT

- Eurozone strains continue
- Political uncertainty about US fiscal position
- Weaker underlying growth momentum in High Income Countries (2012 growth forecast reduced to 1.4% versus 2.2% forecast of mid-2011 with the euro area expected to contract: -0.3%)
- Global stock market volatility (major correction in 2H of 2011 – 6 trillion losses – followed by strong 1Q in 2012, followed by a new downward correction in 4/2012)
- Even though developing countries fundamentals remain strong, contagion is generating significant headwinds and major capital outflows
- Moreover, developing countries have now a more restricted fiscal space compared to 2008

In short: downside risks have increased
Commodity prices have stabilized or are falling

Index, USD price, Jan 2000=100

Sources: Datastream and World Bank DEC Prospects Group
Inflationary pressures have eased almost everywhere

Quarterly inflation rate, annualized

- Long-term average (2000-present)
- 2010Q4
- 2011Q1
- June 2011 or Most recent value

Source: World Bank DEC Prospects Group
2011 GDP compares well with 2007, in most cases

- For example, GDP is below its 2007 level in only 8 out of 30 ECA countries
BUT...
Global economic environment has become much more precarious

- Turmoil since August 2011 has affected financial conditions in developing countries and economic activity worldwide
- Slow growth in large-middle-income countries and high-income Europe makes recovery fragile
- Developing countries expected to grow in 2012 by 5.4%, high-income countries by 1.4% (vs June 2011 forecast of 6.2 and 2.7%)
- Baseline assumes no serious deterioration of conditions, should this materialize impacts for developing countries could be much worse
- Developing countries are vulnerable because of:
  - Reduced fiscal space
  - Maturing short-term and long-term debt
  - Potential deleveraging by banks in high-income world
  - Weaker export demand and remittances flows
  - Commodity prices
38% of developing countries had a government deficit greater than 4% of GDP in 2011 (18% in 2007)

Message: Combination of weaker middle-income growth and eurozone crisis pose significant downside risks.

The “elephant” in the room: the evolving sovereign debt crisis in HICs
Risk “illusion”  
(Source: Blundell-Wignall, 2012)

Figure 5. Spreads before and after Monetary Union

Sources: Datastream, OECD.
Contagion has increased sovereign credit default swap rates worldwide

Change in 5-year sovereign credit-default swap, basis points (as of Jan. 6th, 2012)*

* Change since the beginning of July.

Sources: Bloomberg and World Bank DEC Prospects Group
European banking-sector counterparty-risk concerns persist despite pledge to recapitalize

Interbank overnight spreads, basis points

United States (LIBOR-OIS spread)

Europe (EURIBOR-EONIA spread)

Indications of rising concerns about counter-party risk in European banking system

(Latest reading, 93)

Sources: Datastream and World Bank DEC Prospects Group
The European sovereign debt crisis: some considerations

- Signs of contagion with CDS spreads rising even in some core Euro Area countries
- Banking-sector exposure to European sovereign debt is an issue of concern
- Markets remain uncertain about commitment to adjustment; lack of consensus on the role of the ECB; moreover, the current debt overhang plus fiscal/financial imbalances, and limitations on the use of exchange-rate policy constrain growth prospects
- Uncertainty can transform temporary liquidity problems into solvency crises...
- The impact of ECB’s Long-Term Refinancing Operations (LTROs): QE by stealth (?), relieving tensions on sovereign debt markets (buying time...)
- The “firewall” debate (the role/size of the EFSF/ESM)
The Bank Connection
(Source: Dailami, 2012)

Figure 4. European Banks' Exposure to Home Country and Foreign Sovereign Debt

Source: Based on data from European banking Authority: 2011 EU-wide Stress Test Results.
Policy Actions
(Source: Dailami, 2012)

Figure 6. European Sovereign and Bank Funding Markets Reaction to ECB LTRO: January 2010 – January 2012

Source: Based on data from Bloomberg.
Sovereign debt crises: lessons from history

The debt/GDP equation:

\[ \Delta d_t = -pb_t + (i_t - g_t) \frac{d_{t-1}}{1+g_t} + \text{stock-flow adjustment} \]

\[ \Delta d_t = d_t - d_{t-1} \] , where \( d \) is public debt (D) as a share of GDP

\( pb_t \) = primary balance (i.e., budget balance excluding debt service) as a share of GDP

\( i_t \) = nominal (effective) interest rate on public debt

\( g_t \) = rate of nominal economic growth

History suggests that growth (unlikely in the near future in view of the still significant debt overhang...), fiscal adjustment (positive \( pb \) vs. growing political resistance to fiscal austerity...), inflation (memories of the experience of the 1920s/30s), debt restructuring (financial engineering vs. real debt relief; concerns about contagion...) and financial repression are some of the usual channels to cope with unsustainable debt/GDP ratios
Evolving external and internal imbalances
Deleveraging: The Hard Road Ahead
(Source: Blundell-Wignall, 2012)

Table 4. Sovereign, household and corporate debt

<table>
<thead>
<tr>
<th>2010</th>
<th>Government</th>
<th>Household</th>
<th>Corporate</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>93.6</td>
<td>92.1</td>
<td>49.1</td>
<td>234.8</td>
</tr>
<tr>
<td>Germany</td>
<td>87.0</td>
<td>61.6</td>
<td>66.5</td>
<td>215.1</td>
</tr>
<tr>
<td>France</td>
<td>94.1</td>
<td>55.1</td>
<td>104.7</td>
<td>253.9</td>
</tr>
<tr>
<td>Italy</td>
<td>126.8</td>
<td>45.0</td>
<td>81.4</td>
<td>253.2</td>
</tr>
<tr>
<td>Spain</td>
<td>66.1</td>
<td>85.7</td>
<td>141.6</td>
<td>293.5</td>
</tr>
<tr>
<td>UK</td>
<td>82.2</td>
<td>99.5</td>
<td>112.2</td>
<td>293.9</td>
</tr>
<tr>
<td>Greece</td>
<td>147.3</td>
<td>60.0</td>
<td>62.6</td>
<td>269.9</td>
</tr>
<tr>
<td>Portugal</td>
<td>103.1</td>
<td>95.4</td>
<td>152.9</td>
<td>351.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>102.4</td>
<td>118.9</td>
<td>222.5</td>
<td>443.7</td>
</tr>
</tbody>
</table>

Note: Debt figures focus on loans and securities and ignore equity liabilities, trade credit etc. In the case of Ireland, a financial centre, the figures for corporate debt may be misleading in terms of pressure on the domestic economy. Household debt are loans only.

Sources: US Federal Reserve, Eurostat, Datastream.
The Doing Business Challenge
(Source: World Bank, 2012b)

Southern and Eastern Europe must make it easier to do business
(principal components index of the ease of doing business in 2011, scaled from 0 [poor] to 100 [excellent])

Source: World Bank staff calculations, based on Doing Business 2012; see Chapter 4.
The productivity gap has been growing -- EU15 vs. the US
(Source: World Bank, 2012b)

Productivity growth in Europe’s larger economies has slowed down since the mid-1990s
(EU15 labor productivity, indexed to the United States and Japan)

Source: World Bank staff calculations, based on the Organisation for Economic Co-operation and Development; see Chapter 5.
Europe specializes in old sectors, the US in new
(Source: World Bank, 2012b)

The United States specializes in younger, more R&D intensive products
(relative technological advantage and R&D efforts by young and old innovation leaders in the United States, Europe and the rest of the world)

Note: R&D intensity is measured as the ratio of R&D spending to total sales, for firms established after 1975 (young leading innovators or “Yollies”) or before 1975 (“Ollies”). The relative technological advantage is calculated as the share of each region or country (say Europe) in the R&D of a particular sector (say the Internet) relative to the share of Europe in world R&D; values greater than 1 indicate the region is technology specialized in the sector.

Source: Bruegel and World Bank staff calculations based on the Institute for Prospective Technological Studies R&D Scoreboard; see Chapter 5.
Impact on developing countries can be significant if further deterioration of economic conditions in high-income countries materializes

- Direct financial channel potentially important for Latin America & Caribbean and Europe & Central Asia regions (due to integrated bank ownership)
- Should wealth effects and confidence be affected more markedly than growth could be weaker by two percent or more
- If financial-sector solvency is affected or a market-induced credit event occurs more serious consequences could be envisaged (downside scenarios captured in the Global Economic Prospects forecasts’ slide)
- Implications for world trade non-trivial (temptation to rely on protectionist measures will increase)
- Growing reliance on capital controls: a new form of “beggar thy neighbor” policy?
Evolution of Net ODA (OECD-DAC countries)

CHART 2: COMPONENTS OF DAC DONORS’ NET ODA

Source: OECD, 4 April 2012.
By 2025, major emerging economies are likely to become some of the largest economies in the world
(Source: World Bank, 2011)
The growth gap between developing and developed countries is becoming a structural feature of the world economy
(Source: World Bank, 2011)
The current R&D input landscape

(Scientists & Engineers/Million people versus R&D/GDP)
The global governance challenge

• Current structure set up after WW II under the leadership of the U.S. (the “indispensable” nation)

• Its main pillars included:
  – Trade (GATT/WTO)
  – Global/country financial imbalances (IMF)
  – Resource transfers/development (WB and Regional Development Banks)
  – Security (UN/Security Council)

• Ad hoc groupings have emerged over time to complement these institutional structures: G7/8, G20...

• Challenges on the economic front:
  – Trade: the Doha impasse (the growing appeal of minilateral solutions)
  – Global financial imbalances/development: crisis response vs. structural reforms, availability of resources, relative influence of different shareholders, slow-moving “voice” reforms
World Bank “voice reform” as an example

IBRD Realignment  =>  75% EW + 20% FC +5% DC

An increase of DTC voting power of +3.13% in Phase 2 (2010)

**Economic Weight (EW)**

- Global GDP blend converted at market exchange rates (60%) and PPP exchange rates (40%), three-year average (2006-2008)

For Developed Countries

- Threshold of 90%, i.e. if shareholding is more than 10% below EW, shareholding is brought up to 90% of EW

For DTCs

- *No Threshold* (100% allocation of shares to bring shareholding to EW).
- *PPP Booster*: A minimum increase of +10% in shareholding percentage for members whose GDP share on a PPP-only basis is at least 30% above their shareholding, calculated after allocation of shares based on EW
IDA13-15 contributions

*Eligible members:* *IDA ratio* above 1.0 = higher of (a) share of IDA13-15 contributions/ share of donors’ IBRD shareholding, or (b) share of IDA13-15 contributions/ notional IDA burden share.

*Allocation of additional shares:* +2.0% of IBRD shareholding. Allocate at least 500 shares, but capped at a +10% shareholding increase for smaller shareholders (below 5,000 shares held)

Historical IDA contributions (one-time recognition)

*Eligible members:* *Historical IDA ratio* above 1.0 = share of IDA0-15 contributions/ share of donors’ IBRD shareholding, calculated separately for Developed Countries and for DTCs.

*Allocation of additional shares:* +1.0% of shareholding. Additional recognition of +0.5% of shareholding for donors with historical IDA ratio over 2.0, when calculated for all donors

IDA16 pledges from DTC donors

*Current IDA donors* are allocated shares to maintain voting power if increasing their IDA16 contributions by at least 50% over IDA15.

*New IDA donors* are allocated shares to maintain voting power if contributing to IDA16 at their notional IDA burden share
Development contributions (DC)

Protecting the voting power of the Smallest Poor members

*Eligible members:* Low-income/lower middle income countries < 0.4% shareholding (WDI July 2009, not limited to IDA-only members).

*Allocation of up to 250 shares* to address voting power dilution

Recognition of DTC contributions to IDA, including for IDA13-15, historical IDA contributions, and future contributions for IDA16 (see under FC above)
IBRD Voting Power Realignment/2010:
raising DTC voting power from 42.6% (2008) to 47.19%
(Source: Development Committee, 2010)

<table>
<thead>
<tr>
<th>Country</th>
<th>Pre-Reform</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>16.36%</td>
<td>1</td>
</tr>
<tr>
<td>Japan</td>
<td>7.85%</td>
<td>2</td>
</tr>
<tr>
<td>Germany</td>
<td>4.48%</td>
<td>3</td>
</tr>
<tr>
<td>France</td>
<td>4.30%</td>
<td>4</td>
</tr>
<tr>
<td>UK</td>
<td>4.30%</td>
<td>4</td>
</tr>
<tr>
<td>Italy</td>
<td>2.78%</td>
<td>5</td>
</tr>
<tr>
<td>Canada</td>
<td>2.78%</td>
<td>5</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>2.78%</td>
<td>5</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>2.78%</td>
<td>5</td>
</tr>
<tr>
<td>China</td>
<td>2.78%</td>
<td>5</td>
</tr>
<tr>
<td>India</td>
<td>2.78%</td>
<td>5</td>
</tr>
<tr>
<td>Brazil</td>
<td>2.07%</td>
<td>12</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Post-Phase 2 Voice Reform</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.85%</td>
<td>1</td>
</tr>
<tr>
<td>6.84%</td>
<td>2</td>
</tr>
<tr>
<td>4.00%</td>
<td>4</td>
</tr>
<tr>
<td>3.75%</td>
<td>5</td>
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<tr>
<td>3.75%</td>
<td>5</td>
</tr>
<tr>
<td>2.64%</td>
<td>8</td>
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<tr>
<td>2.43%</td>
<td>9</td>
</tr>
<tr>
<td>2.77%</td>
<td>7</td>
</tr>
<tr>
<td>2.77%</td>
<td>7</td>
</tr>
<tr>
<td>4.42%</td>
<td>3</td>
</tr>
<tr>
<td>2.91%</td>
<td>6</td>
</tr>
<tr>
<td>2.24%</td>
<td>10</td>
</tr>
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</table>
Some reflections

• Voice reform at the WBG
  – The “tyranny” of the 100 per cent...
  – Conflicting values (economic weight x donor generosity)
  – Negotiating tactics

• More broadly:
  – U.S. has de facto been the main source of support for global public goods (open trading and financial system, security, ...): the “indispensable nation” in the post-WWII era, but it is now increasingly constrained by fiscal and political considerations
  – Emerging powers seem much less convinced of the benefits of financing/supporting global public goods
  – “Old” powers will resist rapid transformation of institutional structures/governance
Concluding remarks

• We are entering a new chapter in the economic adjustments associated with the Great Recession. Europe and its special brand of institutional arrangements are at the very core of the crisis resolution: government/EU/ECB/IMF actions have bought time for structural reform, but markets are not patient…;

• Recent turbulence in financial markets and uncertainty about future prospects is impacting growth in both high-income (HICs) and developing countries (DCs), but divergent growth trends between HICs and DCs are expected to continue;

• The Great Recession has increased skepticism about the benefits of globalization: the danger of trade and financial protectionism is rising;

• In a multipolar world economy (in which several major emerging countries are attaining growth pole status), international relations will take on a much more complex pattern, with South-South trade, investment, and finance linkages requiring greater attention;

• The global governance system is under strain: the “indispensable-nation gap” and the growing pressure to reform global institutions (no easy fixes).
Jurre Hermans’ entry to the Wolfson Prize (how to manage an orderly break-up of the euro)
References

• Battelle, 2010, “2011 Global R&D Funding Forecast.”
• IMF, World Economic Outlook, several years.