

# Economic Outlook: The Road Ahead

Jeffrey Frankel

Harpel Professor of Capital Formation & Growth



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## Topics


- The US recession 
- The global economy 
- International forecasts for 2010 
- The G-20 in 2010 
- The problem of global imbalances 

- Addenda on the crisis of 2007-2009
  - Origins of the financial crisis
  - Policy response: How did we avoid a Great Depression?
  - Intellectual implications for the field of economics

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## The US Recession



- The US recession started in Dec. 2007 according to the NBER Business Cycle Dating Committee. 
- In May 2009, the recession's length passed the postwar records -- 1973-75 & 1981-82
  - = 16 months
  - One has to go back to 1929-33 for a longer downturn.
- Also the most severe, by most measures:
  - rise in unemployment rate, job loss, output loss....

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## BUSINESS CYCLE REFERENCE DATES

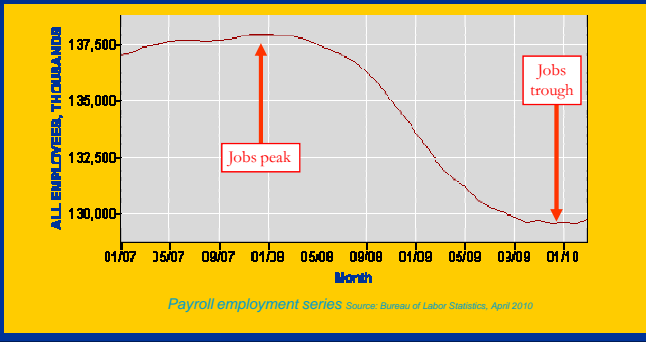
Source: NBER

Peak	Trough	Contraction
<i>Quarterly dates are in parentheses</i>		<i>Peak to Trough</i>
August 1929 (III)	March 1933 (I)	43 months
May 1937 (II)	June 1938 (II)	13
February 1945 (I)	October 1945 (IV)	8
November 1948 (IV)	October 1949 (IV)	11
July 1953 (II)	May 1954 (II)	10
August 1957 (III)	April 1958 (II)	8
April 1960 (II)	February 1961 (I)	10
December 1969 (IV)	November 1970 (IV)	11
November 1973 (IV)	March 1975 (I)	16
January 1980 (I)	July 1980 (III)	6
July 1981 (III)	November 1982 (IV)	16
July 1990 (III)	March 1991 (I)	8
March 2001 (I)	November 2001 (IV)	8
December 2007 (IV)	June 2009 (II) or later [not yet declared]	> 18 months
Average, all cycles: 1854-2001 (32 cycles)		17
<b>1945-2001 (10 cycles)</b>		<b>10</b>

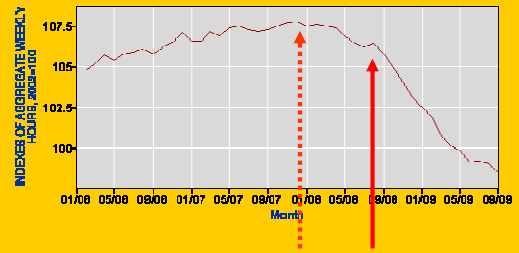
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US employment peaked in Dec. 2007,  
 which is one reason why  
 the NBER BCDC dated the peak from that month.

8 million jobs were lost over the next two years.

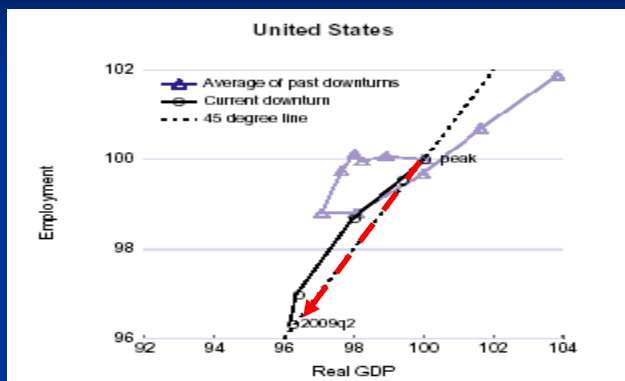


My favorite monthly indicator:  
 total hours worked in the economy

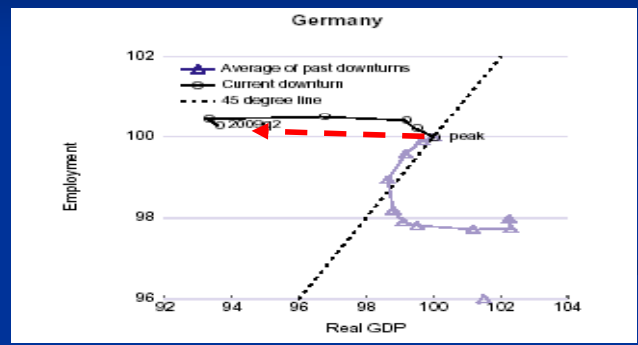


It confirms: US recession began Dec. 07, turned severe in Sept. 08,  
 when the worst of the financial crisis hit (Lehman bankruptcy...)

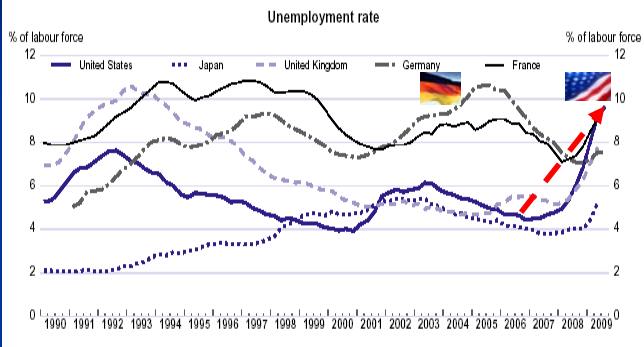
US employment fell fully in proportion to GDP,  
 unlike the “labor hoarding” pattern of the past.



In Germany, by contrast,  
 the recession has shown up only in GDP,  
 not at all in employment.

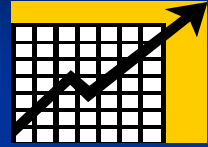


## Unemployment in the US has risen above Europe for the first time in decades

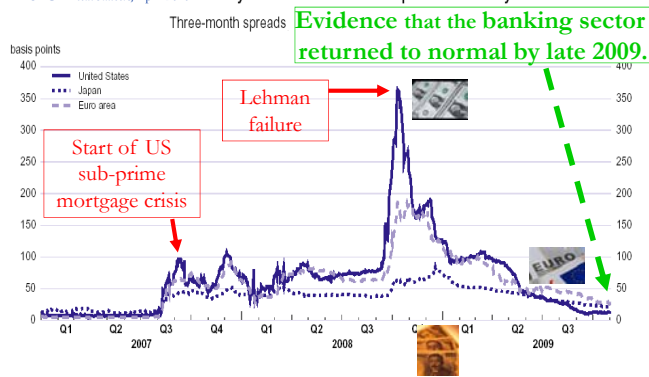


## Most indicators began to improve in mid or late 2009

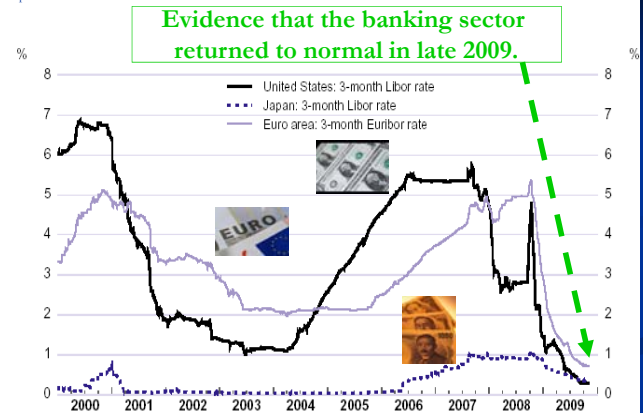
- Interbank spreads
- Output
- Stock market
- Consumer confidence & spending
- Even housing measures have bottomed out.
- The labor market has been terrible.
  - But even it has responded with lags no worse than usual.



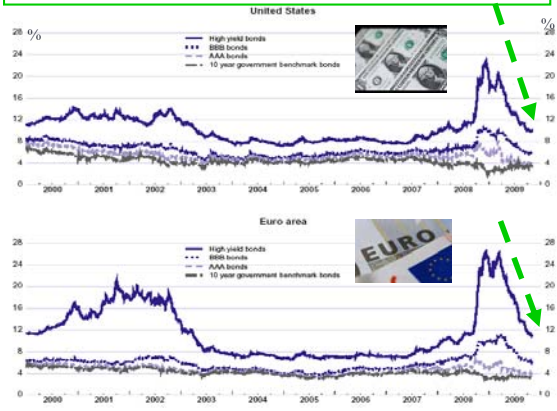
### OECD Econ. Outlook, April 2010 Money market conditions have improved remarkably



### OECD Economic Outlook, April 2010 Interbank lending rates have fallen to very low levels



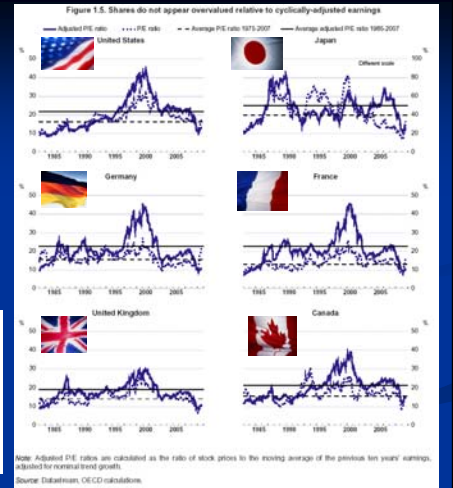
**Corporate bond rates have come back down too.**



Now < interest rates in the (mild) 2001 recession.

According to the OECD, equities are not overpriced: P/E ratios are about normal.

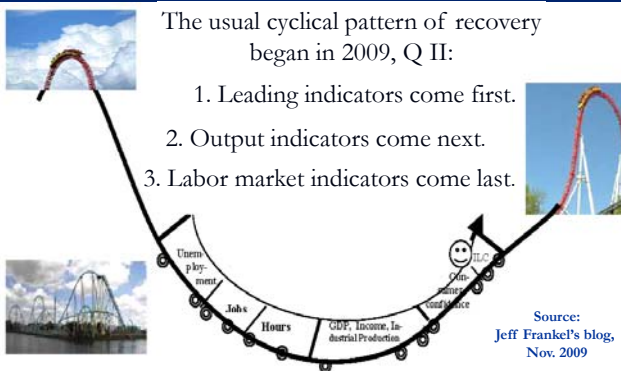
(though I wonder if they have gone back far enough in computing the average.)



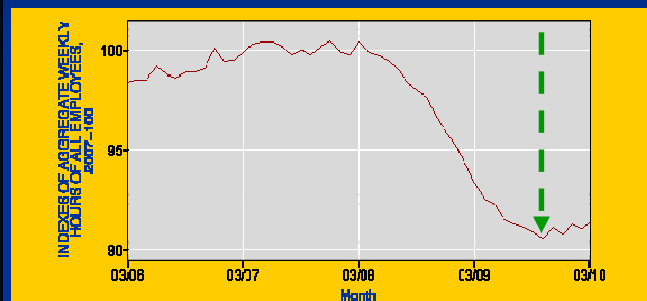
The economic roller coaster went into free-fall in the 3<sup>rd</sup> quarter of 2008.

The usual cyclical pattern of recovery began in 2009, Q II:

1. Leading indicators come first.
2. Output indicators come next.
3. Labor market indicators come last.



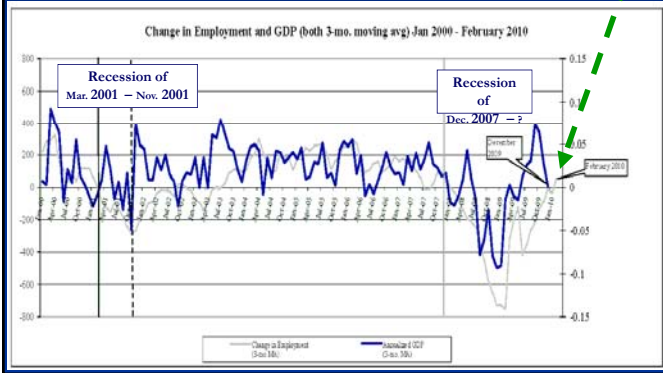
**Total hours worked in the US economy**  
(an indicator that does not lag as far behind as unemployment)  
**began to turn upward in October 2009**



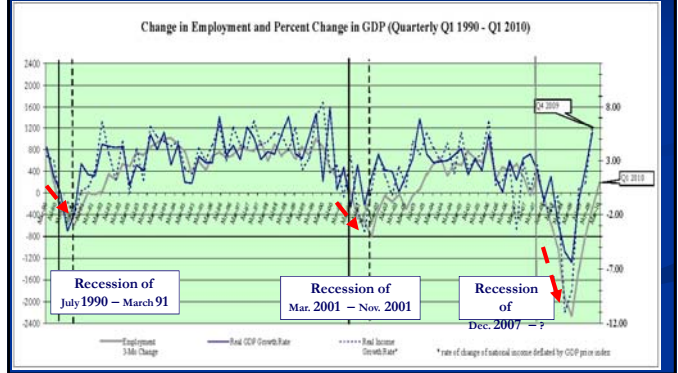
Source: New series from BLS covering the entire private economy. 4/8/2010

## Employment Lags Behind GDP

In this recession U.S. job loss has been especially bad, but the lag in recovery behind GDP has not been unusual.



National income has been more reliable than GDP, even though they are supposed to measure the same thing.



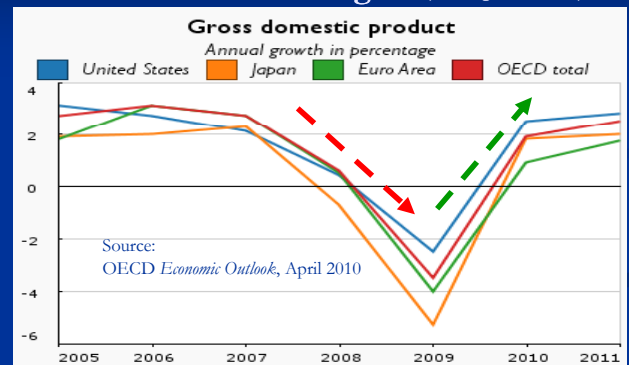
## Danger of a W-shaped recession?

- Demand growth in the last 3 quarters came in large part from:
  - fiscal stimulus, &
  - ending of firms' inventory disinvestment.
- **Both sources of stimulus will run down in 2010.**
  - We must hope consumption & investment are catching fire.
- Furthermore, **there could always be new shocks:**
  - Another Iceland or Dubai or Greece
  - Hard landing for the \$
  - Geopolitical/oil shock...
- I put the odds of a double dip recession as
  - rather small, but
  - big enough to have persuaded the NBER BCDC in our April 8 meeting to wait longer before declaring the 2009 trough.

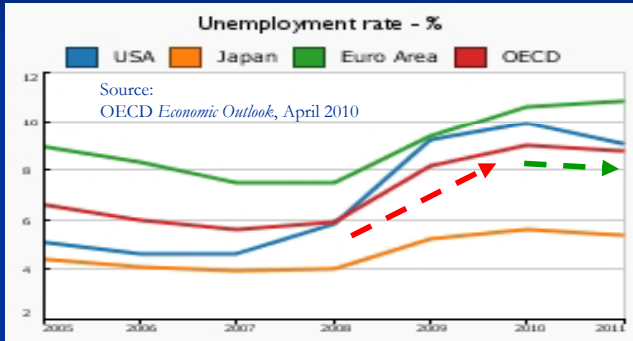


NBER

The global economy quickly followed and the US into recession, and now back out again (Source: OECD, April 2009, QIII)

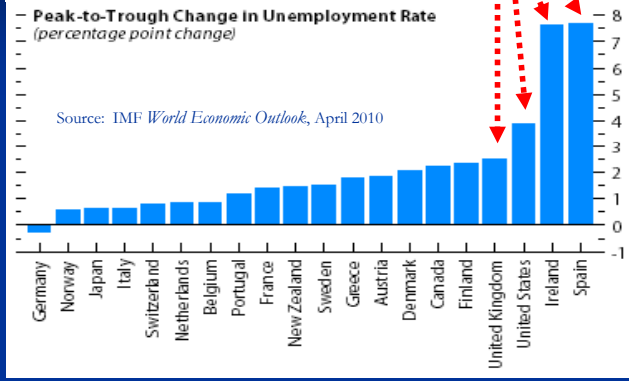


## Unemployment is forecast to come down only slowly (typical of financial crashes)

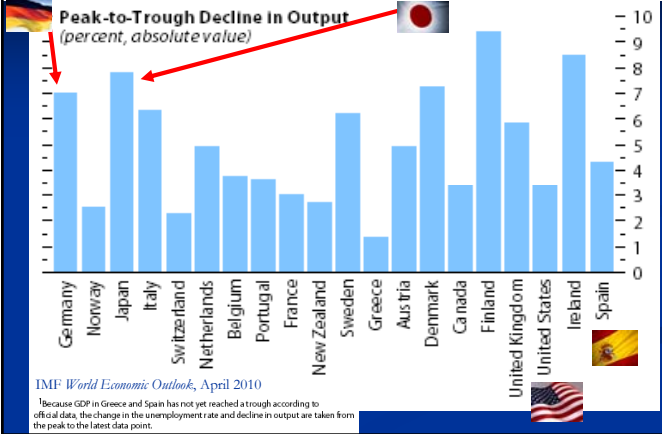


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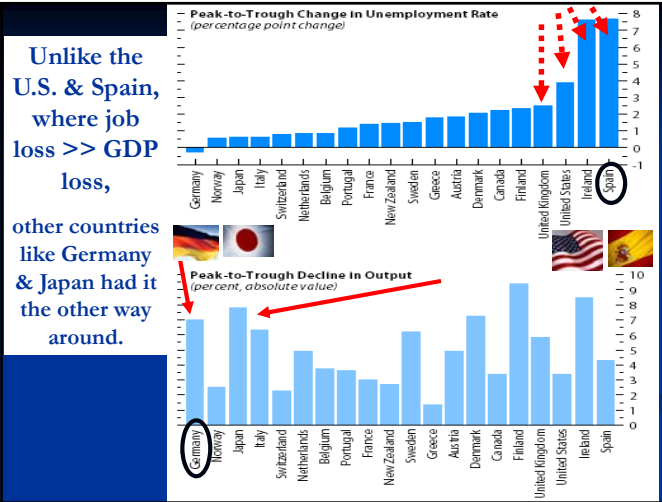
## The countries with the big housing bubbles suffered the most severe recessions



## Unlike the U.S. & Spain, where job loss >> GDP loss, other countries like Germany & Japan had it the other way around.

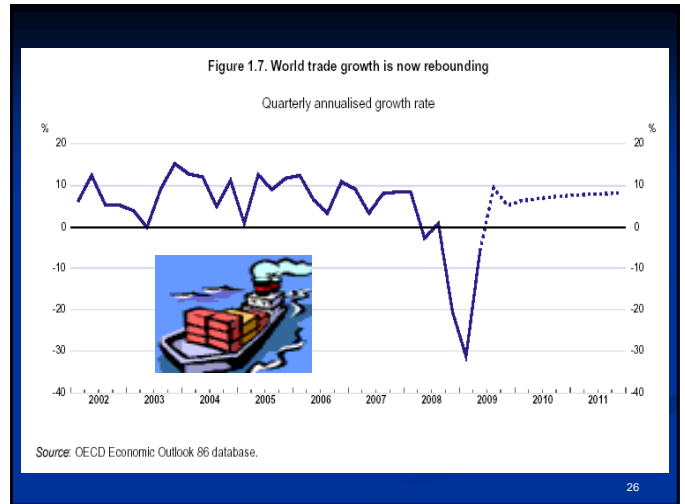


## Unlike the U.S. & Spain, where job loss >> GDP loss, other countries like Germany & Japan had it the other way around.



## De-coupling turned out to be real after all

- at least with respect to East Asia, which has rebounded very strongly over the last year,
  - after a sharp loss of exports over the preceding year,
    - from 2008 Q1 to 2009 Q1.
- China's growth
  - has not only returned to its blistering pace of > 10%
  - but by now is a source of *global* growth
    - because China is now a much larger share of the world economy than in the 1980s or 90s.
- India, Indonesia, & other Asian countries also weathered the global recession well, and are growing strongly.



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## Global Growth Forecasts

RGE *Global Economic Outlook* Q2 2010

Draft, for release April 20

Roubini Global Economics

Real GDP (% chg, y/y)



Country	2009	2010	
USA	-2.4	2.8	1 Includes USA, Canada, Japan, UK, Eurozone, Sweden, Denmark, Australia & NZ.
Japan	-5.2	2	
Eurozone	-4.1	0.9	2 Includes Japan, China, India, Hong Kong, Indonesia, Malaysia, Philippines, Singapore, Vietnam, Korea, Taiwan & Thailand.
UK	-5	1.1	
G7	-3.4	2.2	3 Brazil, Argentina, Mexico, Chile, Peru, Colombia & Venezuela.
Advanced Economies 1	-3.4	2	
Asia 2	3.6	6.9	4 Turkey, Russia, Kazakhstan, Ukraine, Czech Rep., Hungary, Slovakia, Poland, Romania, Bulgaria, Egypt, Saudi Arabia, UAE, Israel, Nigeria, S. Africa
Asia ex-Japan	5.8	8.2	
Latin America 3	-2.1	4.3	5 Brazil, India & China; or BRICs excl. Russia.
EMEA 4	-3.5	3.1	
BRICs	4.9	8.3	
BICs 5	7	9	
World	-0.8	3.7	

## Five leading forecasts of growth in 2010

Source: Michael Mussa, *Global Economic Prospects for 2010 and 2011*, PIIE, April 8, 2010



	Mussa, PIIE, April	IMF, Jan. 2010	<i>Economist</i> average, March	<i>Consensus</i> average, March	<i>Blue Chip</i> average, March
U.S.	4.0	2.7	3.1	3.1	3.1
Japan	2.7	1.7	1.7	1.5	1.8
Euro area	2.0	1.0	1.2	1.1	1.3
UK	2.0	1.3	1.3	1.4	1.2

## The G-20 in 2010



Canada & Korea will host the summit meetings in June & November, respectively.

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## The true significance of the G-20 in 2009

- A turning point: The more inclusive group has suddenly become central to global governance, eclipsing the G-7, and thereby at last giving major developing/emerging countries some representation,  
- after decades of fruitless talk about raising emerging-market representation in IMF. 
- The G-20 accounts for 85% of world GDP.

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## Four possible G-20 agenda items for 2010

- Financial regulatory reform
  - Capital adequacy ratios should be higher, and less procyclical
  - Surcharges on banks with large liabilities.
  - Most stays at the national level: mortgages, exec.compensation...
- Macroeconomic exit strategies
- Global imbalances between developing countries and industrialized
  - US and China should both admit responsibility
    - US: the budget deficit is too big. Needs to be fixed.
    - China: RMB is too low. Needs to be unfixed.
- Post-Copenhagen progress toward new agreement on climate change, ideally to take effect 2012. 

## Two principles of multilateral institutions

1. It is inevitable that more power go to large-GDP/creditor countries than small.
  - This is why the IMF works better than the UN .
  - The problem is that China, India, Korea, Brazil, etc., *are* large enough to be included... Hence the G-20.
  - Decisions must leave small countries better off, of course, if they are to go along.
2. Conversation is not possible with more than 20 in the room.

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## Example: many rounds of trade negotiations under the GATT.

- Worked well for years,
  - with small steering groups (US-EU, the Quad & G-7)
  - and few demands placed on developing countries.
- Failed when developing countries had become big enough to matter,
  - but were not given enough role:
  - Doha Round



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## Conversation is not possible with more than 20 people in the room.

- Delegates just read their talking points.
- Latest evidence: The Climate Change CoP in Copenhagen
  - The UNFCCC proved an ineffectual vehicle
    - Incompetent management of logistics
    - Small countries repeatedly blocked progress
  - Obama was able to make more progress at the end with a small group of big emitters.
- To be honest, the G-20 is too big (30).
  - My recommendation: an informal steering group *within* the G-20.



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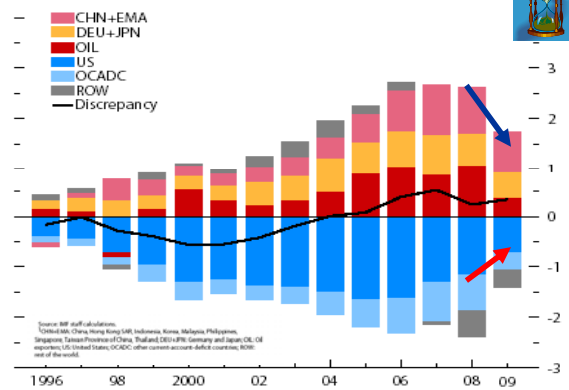
## The problem of current account imbalances,

- especially the US CA deficit & China's surplus,
- was the most salient global macroeconomic issue on the eve of the financial crisis.
- Imbalances narrowed sharply in 2009;
  - the US deficit fell by 1/2 ;
  - China's trade surplus actually fell to 0 in March.
- Problem solved?
- The imbalances will now resume widening.



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Global imbalances narrowed sharply in 2009 owing to both cyclical and more lasting developments. Imbalances are projected to widen once again as the global recovery takes hold.



## Economists were (are) split between



those who saw the US deficit as unsustainable, requiring a \$ fall,

and those who saw (see) no problem.

- Ken Rogoff \*
- Maury Obstfeld
- Larry Summers
- Martin Feldstein
- Nouriel Roubini
- Menzie Chinn
- Me
- Lots more
- Ben Bernanke
- Ricardo Caballero \*
- Richard Cooper
- Michael Dooley
- Pierre-Olivier Gourinchas
- Alan Greenspan
- Ricardo Hausmann
- Lots more

\* Some claim that the financial crisis of 2007-09 fits their theories.

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## The events of 2007-09 struck some major blows against *both* interpretations of CA.

- Most of us in the **unsustainability camp** would have predicted that something like the US sub-prime mortgage crisis would cause a big fall in the \$.
  - Instead, the \$ strengthened.
- Most of those in the **sustainability camp** had been arguing that the US has uniquely superior assets (corporate governance, securities markets, bank regulation...)
  - Instead, the crisis showed the US system to suffer serious flaws
    - of crony capitalism like other countries (Simon Johnson, Ragu Rajan)
    - or – worse – excessive deregulation (Joe Stiglitz)
- The answer, for the moment: The \$ and US Treasury bills still play unique roles in the world monetary system.

## When will the day of reckoning come?



- It didn't come in 2008: The financial crisis caused a flight to quality which evidently still means a flight to US \$.

- Chinese warnings in 2009 may have augured a turning point:



- Premier Wen worried US T bills will lose value. He urged the US to keep its deficit at an “appropriate size” to ensure the “basic stability” of the \$ (Nov).
- PBoC Gov. Zhou proposed replacing \$ as international currency, with the SDR (March 09).



## Soon we must return toward fiscal discipline.

- The only way to do this is *both* reduce spending & raise tax revenue, as we did in the 1990s.
- Tax revenue
  - Let Bush's tax cuts for the rich expire in 2011.
  - Phase in carbon tax or auctioning tradable emission permits
  - Or introduce a Value Added Tax
  - Curtail expensive and distorting tax expenditures
    - E.g., Tax-deductibility of mortgage interest
- All politically difficult, needless to say.
- Any solution requires:
  - Honest budgeting
  - PAYGO
  - Wise up to politicians who claim they want to do it entirely on the spending side & but who raise spending when they get the chance.

## ■ Spending

- Cuts in farm subsidies for agribusiness & farmers (Congress told Obama “no” last year)
- Cut unwanted weapons systems (a rare success: the F22 fighter)
- Cut manned space program...



## ■ Social security

- Raise retirement age – just a little
- Progressively index rate of future benefit growth to inflation
- If necessary, raise the cap on social security taxes.

## ■ Health care

- Encourage hospitals to standardize around best-practice medicine
  - to pursue the checklist that minimizes patient infections and
  - to avoid unnecessary medical tests & procedures.
  - Lever: making Medicare payments conditional on these best practices .
- Curtail corporate tax-deductibility of health insurance,
  - especially gold-plated.

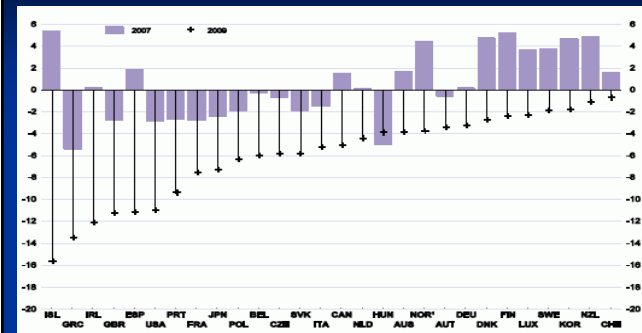
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## When will US adopt the tough measures to get back to fiscal sustainability?

- Ideally, we would now adopt measures that would begin to go into effect in 2011-12 and over the coming decades – repeating the 1990s success.
- That is unlikely politically, with Republicans opposing all Obama initiatives.
- Hopefully, then, after the 2012 presidential elections.
- Otherwise, in response to future crises.

## Public finances have weakened significantly *everywhere*

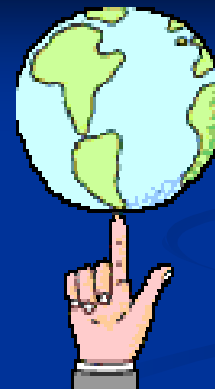
General government balance, in per cent of GDP



Note: Government balance for 2009 is an estimate for some countries. Countries are ranked according to the government balance in 2009.

Source: OECD *Economic Outlook*, April 2010

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## Addenda on the crisis of 2007-2009

1. Origins of the financial crisis
2. Policy response: How did we avoid a Great Depression?
3. Intellectual implications for the field of economics

## Appendix 1: Six root causes of financial crisis

### 1. US corporate governance falls short

- E.g., rating agencies;
- executive compensation ...
  - options;
  - golden parachutes...



### 2. US households save too little, borrow too much.



### 3. Politicians slant excessively toward homeownership

- Tax-deductible mortgage interest;
- FannieMae & Freddie Mac;
- Allowing teasers, NINJA loans, liar loans...



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## Six root causes of financial crisis, cont.

### 4. The federal budget

has been on a reckless path since 2001,

- reminiscent of 1981-1990



### 5. Monetary policy was too loose during 2004-05,

- accommodating fiscal expansion, reminiscent of the Vietnam era.



### 6. Financial market participants grossly underpriced risk 2005-07.

- Ignoring possible shocks such as:
  - housing crash,
  - \$ crash,
  - oil prices,
  - geopolitics....



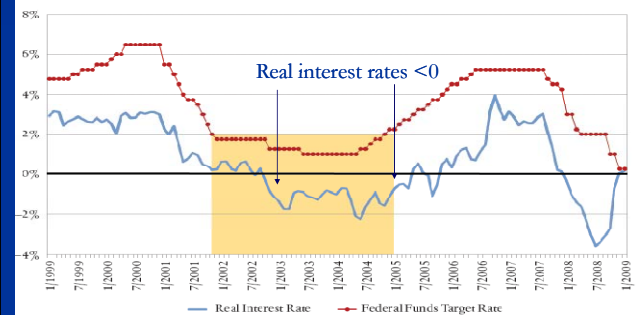
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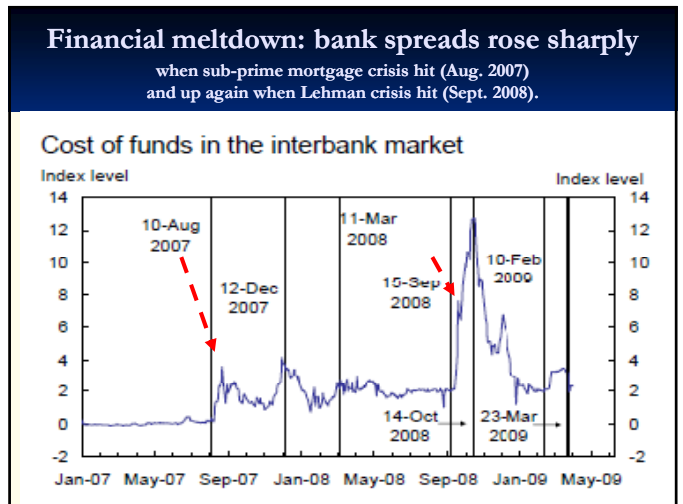
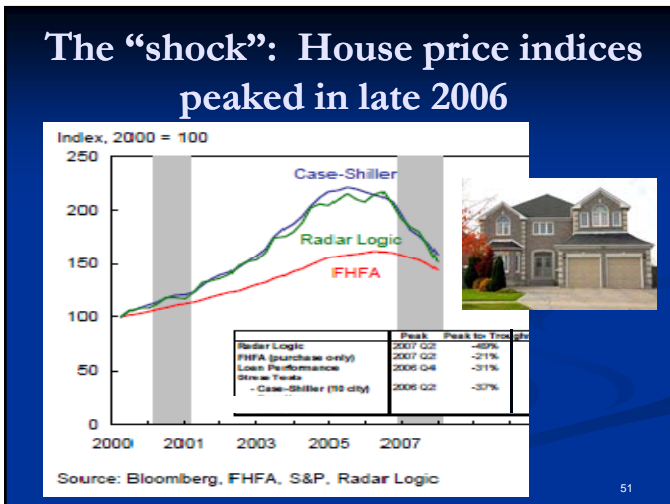
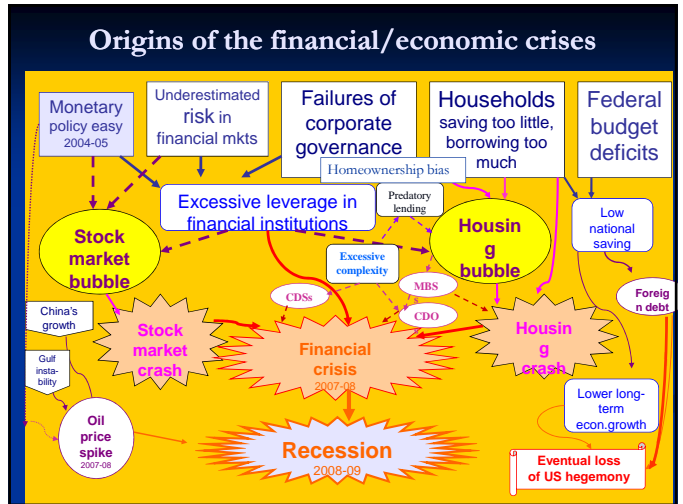
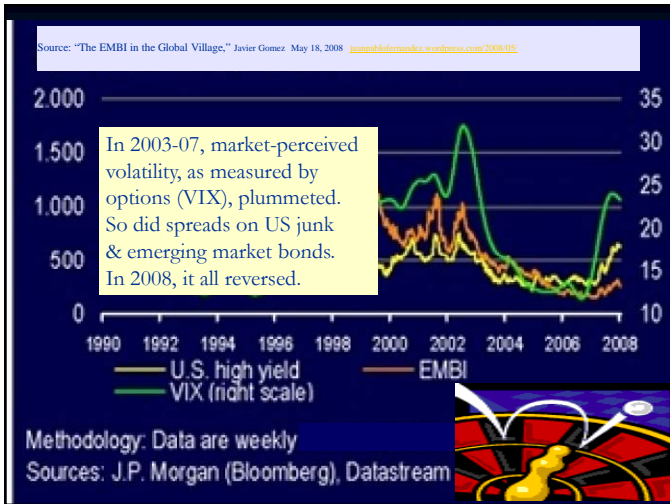
## US real interest rate < 0, 2003-04

Source: Benn Steil, CFR, March 2009



FIGURE 1. U.S. REAL INTEREST RATE AND THE FEDERAL FUNDS TARGET RATE





## Appendix 2: Policy Response -- How did we avoid another Great Depression?

- We learned important lessons from the 1930s and, for the most part, didn't repeat the mistakes we made then.



We learnt from the mistakes of the 1930s.

- **Monetary response:** good this time



- **Fiscal response:** relatively good, *but*:

- constrained by inherited debt
- and congressional politics.



- **Trade policy:**

- Some slippage, e.g., Chinese tires.
- But we did not repeat 1981 auto quotas or 2001 steel tariffs
- let alone Smoot-Hawley !



- **Financial regulation?**

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## U.S. Policy Responses



- **Monetary easing** was unprecedented, appropriately avoiding the mistake of 1930s. (graph)

- Policy interest rates  $\approx 0$ .

- The famous liquidity trap is not mythical after all.
- Lending, even inter-bank, built in big spreads.

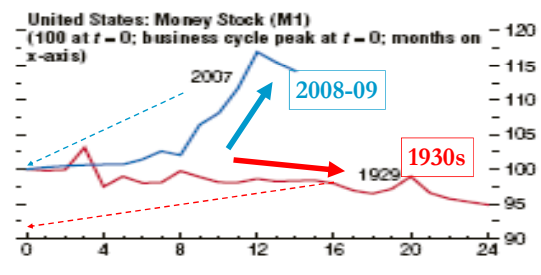
- Then we had aggressive quantitative easing:

- the Fed purchased assets not previously dreamt of.

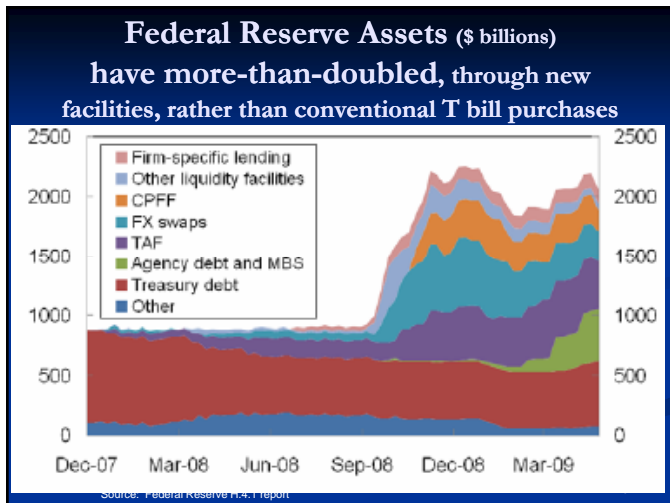
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The Fed certainly did *not* repeated the mistake of 1930s: letting the money supply fall.


### Countercyclical Policies and Output-Inflation Dynamics



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### Policy Responses, continued



The policy of “financial repair”

- succeeded in getting the financial system going again,
  - thereby precluding a new Great Depression,
  - yet without “nationalization” of the banks.
- Contrary to almost all commentary at the time of TARP:
  - The conditions imposed on banks were enough to make them balk at keeping the funds.
  - The banks have now paid back the taxpayer at a profit.
  - Geithner’s stress tests fulfilled their function of telling strong banks from weak.

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### Next up in US: Financial reform. What is needed?

- **Lending**
  - **Mortgages**
    - Consumer protection, including standards for mortgage brokers
    - Fix “originate to distribute” model, so lenders stay on the hook.
    - Remove pro-housing bias in policy. (But politicians remain unanimously pro.)
  - **Banks:**
    - Regulators shouldn’t let banks use their own risk models;
    - should make capital requirements higher & less pro-cyclical.
    - Is “too big to fail” inevitable? (The worst is to say “no” and then do “yes.”)
  - Extend bank-like regulation to “near banks.”
    - Regulators need resolution authority.
    - Segmentation of function:
      - Volcker rule?
      - or all the way back to Glass-Steagall? (I don’t think so.)

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### Financial reforms continued

- **Executive compensation**
  - Compensation committee not under CEO.
    - Maybe need Chairman of Board.
  - Discourage golden parachutes & options,
    - unless truly tied to performance.
- **Securities**
  - **Regulatory agencies:** less decentralization of authority?
  - **Regulate derivatives:**
    - Create a central clearing house for CDSs .
  - **Credit ratings:**
    - Reduce reliance on ratings: AAA does not mean no risk.
    - Reduce ratings agencies’ conflicts of interest.

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## Policy Responses, continued



### ■ \$787 b fiscal stimulus passed Feb. 2009.

- Good old-fashioned Keynesian stimulus
  - Even the principle that spending provides more stimulus than tax cuts has returned;
    - not just from Larry Summers, e.g.,
    - but also from Martin Feldstein.
- Is \$800 billion too small? Too large?
  - Yes: Too small to knock out recession ;
  - too large to reassure global investors re US debt.
    - Also Congress was not willing to vote for more, especially on the spending side.



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## Bottom line of macroeconomic policy response:

- The monetary and fiscal response was sufficient to halt the economic free-fall.
- It won't be enough to return us rapidly to full employment and potential output.
- Given the path of debt that was inherited in 2009, it is unlikely that more could be done.
  - Chinese officials already questioning our creditworthiness
  - Questions asked about US AAA rating
  - Risk of hard landing for the \$

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## Appendix 3: Intellectual implications of the crisis for economics

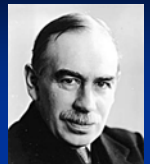


- The return of Keynes
  - And 4 others who mainstream theory had forgotten.
- The implications for Inflation Targeting
- 8 economists who got parts right
- In what direction should macro theory now move?
  - The phylloxera analogy: reimporting models from emerging markets.



## The return of Keynes

- Keynesian truths abound today:
  - Origins of the crisis
  - The Liquidity Trap
  - Fiscal response; spending vs. tax cuts
  - Motivation for macroeconomic intervention: to save market microeconomics
  - International transmission
  - Need for coordinated expansion (now the G20)



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## Motivation for macroeconomic intervention

- The view that Keynes stood for big government is not really right.
  - He wanted to save market microeconomics from central planning, which had allure in the 30s & 40s,
  - by using macroeconomic demand to return to equilibrium.
- Some on the Left reacted to the 2008 crisis & election by hoping for fundamental overhaul of the economic system.
  - But the policy that prevails today is the same.



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- The origin of the crisis was an asset bubble collapse, loss of confidence, credit crunch....



- like Keynes' animal spirits or beauty contest .

- Add in von Hayek's credit cycle,
- Kindleberger's "manias & panics"
- the "Minsky moment,"
- & Fisher's "debt deflation."



- The origin this time was *not* a monetary contraction in response to inflation as were 1980-82 or 1991.
- But, rather, a credit cycle: 2003-04 monetary expansion showed up only in asset prices.

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## Who got pieces of it right, beforehand?



- Krugman: If a Depression can happen in Japan, it can happen in any modern economy.
- Rajan: Failures of corporate governance.
- BIS (Borio & White): Too-easy credit, via asset prices, leads to crises -- with no inflation in between.
- Shiller: US housing price bubble.
- Gramlich: Homeowners are being sold mortgages that they can't repay.
- Rogoff: "This Time Is *Not* Different."
- Roubini: The recession will be severe.

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## "Where should mainstream macro go, in light of the 2007-09 global financial crisis?"

- Some models that had been thriving in an emerging markets context may now help answer this question.
- Some were applications of models originally designed for advanced-country financial markets, but never fully incorporated into the mainstream macro core.
- A possible explanation why they had been transplanted to emerging markets: assumptions of imperfections in financial markets were considered more acceptable there, than in the context of advanced economies.

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Financial crises:  
Not just for emerging markets anymore.

### An analogy

- In the latter part of the 19th century most of the vineyards of France were destroyed by Phylloxera.
- Eventually a desperate last resort was tried: grafting susceptible European vines onto resistant American root stock.
- Purist French vintners initially disdained what they considered compromising the refined tastes of their grape varieties.
- But it saved the European vineyards, and did not impair the quality of the wine.
- The New World had come to the rescue of the Old.



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### Implications of the 2008 financial crisis for macroeconomics?

- In 2007-08, the global financial system was grievously infected by “toxic assets” originating in the United States.
- Many ask what fundamental rethinking is necessary to save orthodox macroeconomic theory.
- Some answers may lie with models that have been applied to the realities of emerging markets.
- Purists may be reluctant to seek help from this direction.
- But they should not fear that the hardy root stock of emerging market models is incompatible with fine taste.

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### What are some of these models?

- Asymmetric information
  - Credit rationing (Stiglitz...)
  - Need for collateral (Kiyotaki & Moore, Caballero...)
  - Leverage cycle (Geanakoplos)
- The credit channel (Bernanke & Gertler...)
- Balance sheet effects (Calvo...)
- Bank runs & multiple equilibria (Diamond & Dybvig; Velasco...)
- Speculative attacks (Krugman; Obstfeld; Morris & Shin...)
- Moral hazard & incentive incompatibility (Dooley...)



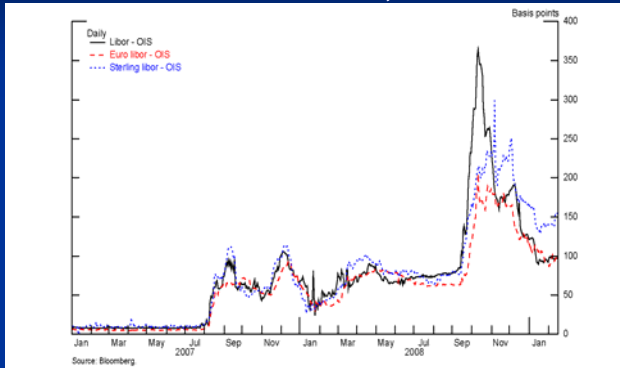
71



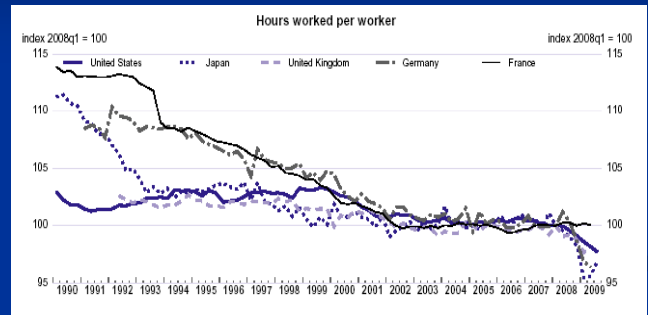
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### Spread of LIBOR over OIS (3-Month) Interest Rates Jan. 2007-February 2009

Source: Steve Kamin, FRB

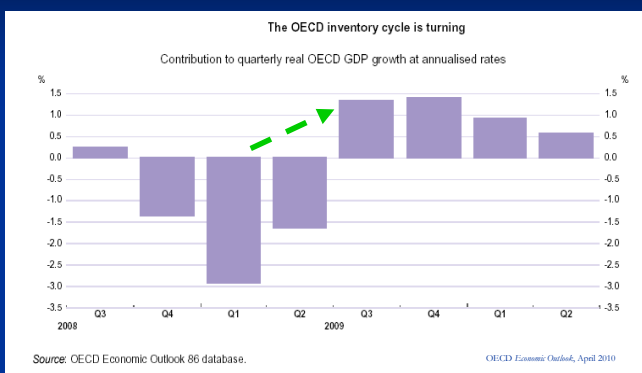


### In the recession of 2008-09, the length of the workweek fell sharply below its levels of 2003-07.



Source: OECD Economic Outlook, April 2010

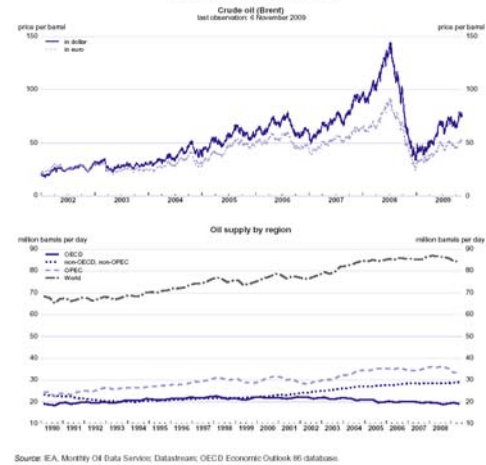
### The end of inventory dis-investment was a source of demand growth in 2009 Q3 – 2010 Q1



Source: OECD Economic Outlook 86 database.

OECD Economic Outlook, April 2010

Figure 1.11. Oil prices have rebounded



Source: IEA, Monthly Oil Data Service; Datastream; OECD Economic Outlook 86 database.