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October 8, 2009

The Great Recession of 2007-09: Analysis and Prospects

Robert C. Shelburne, *United Nations Economic Commission for Europe*



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The Great Recession of 2007-09: Analysis and Prospects

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**Keynote Address to the
UN-WTO Tourism Resilience Committee
Astana, Kazakhstan**

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The location of the Economic Commission for Europe in the Palais des Nations
in Geneva, Switzerland

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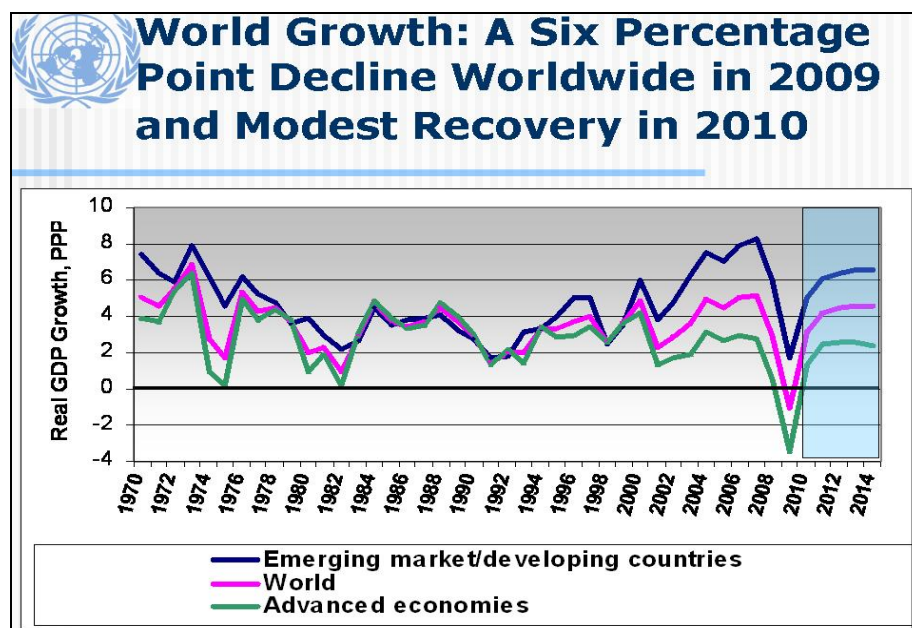
Robert C. Shelburne



The Great Recession of 2007 - 2009

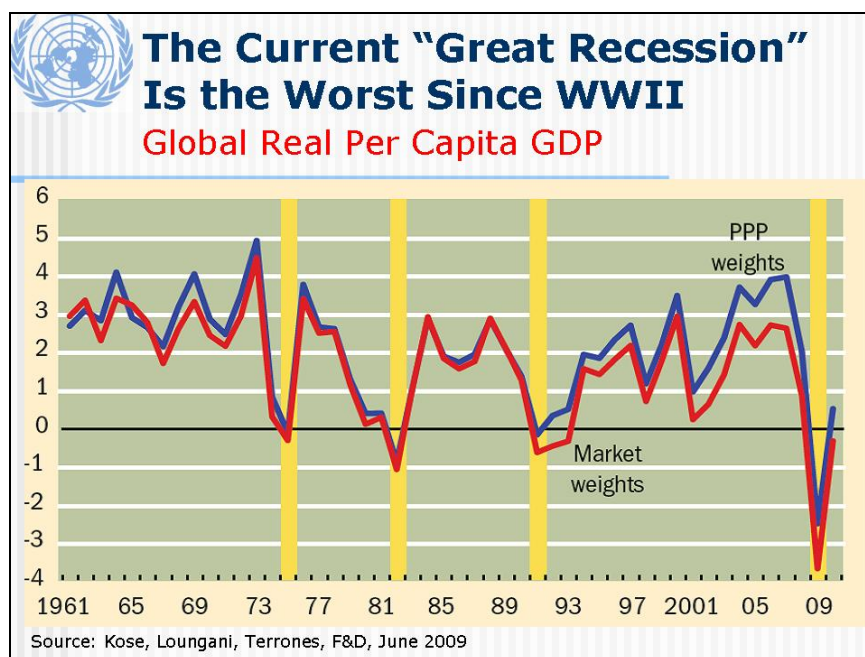
- **The most severe financial shock since the 1930s**
- **The worst economic downturn since WWII**
- **The unprecedented policy response has avoided a second great depression**
- **There will be significant long-term implications for living standards and institutions**

The global economy is now in the process of gradually recovering from the most severe financial shock and the worst economic downturn since the Great Depression of the 1930s. Since the 1960s this has been the first year in which global real GDP has actually declined. If governments throughout the world had not co-operated and implemented unprecedented monetary and fiscal expansions and extraordinary financial market interventions, in all likelihood the world would have experienced a second Great Depression. This current recession, which will probably be remembered as the Great Recession, will have significant implications for economic growth and living standards for years to come and will result in significant changes in both national and international economic institutions.



The current crisis in historical perspective

Although the current crisis is rightly characterized as a global crisis, the intensity of the economic downturn has varied quite significantly throughout the world. Economic growth has been much lower in the advanced economies than in the developing ones; however in both regions the decline in growth in 2009 (from 2006-2007 levels) has been about the same, that being about 6 percentage points. The east European and transition economies have suffered the worst; most likely 12 economies in that region will ultimately require some type of IMF support. The recession has also been quite deep in the US and western Europe. Asia has been less impacted; more specifically growth in China and India has remained impressive although down slightly from the very rapid levels of a few years ago. The growth in these economies is especially important from an humanitarian point of view since they are so large with over a third of the world's population and since they contain over a half of the world's poor. Nevertheless, world poverty has increased by 90 million, unemployment by 50 million, and the progress in achieving the MDGs has been significantly set back.



In the last 60 years the global economy has only experienced four significant recessions¹; these were in 1975, 1982, 1991 and 2009. From the fact that there have only been four, it is clear that global recessions are fairly rare.

¹ Defined as a situation when world real per capita income declined, see Ayhan Kose, Prakash Loungani, and Marco Terrones, Out of the Ballpark, *Finance and Development*, June 2009, pp. 25-28.

Thus although there was the Asian financial crisis of 1997-98, it did not spread to the advanced economies, and the high-tech bust that resulted in recessions in the advanced economies in 2001 did not spread to many of the developing economies.

Of these four global recessions, 2009 has been the worst. In terms of the decline in GDP, industrial production, and investment the current recession has been about twice as great as that of the second worst, which occurred in 1982. But what has been really different about this recession has been the declines experienced in external economic flows between countries. The declines in both merchandise trade and capital flows have been over ten times greater than what occurred in 1982. Thus during this downturn trade and capital flows literally collapsed. For 2009, world trade is likely to decline by 12%, but the exports of many countries have fallen much more. Capital flows to emerging markets have fallen over 80%.

The 1982 downturn was similar to this one in that they both resulted from the fact that billions of dollars of financial assets became close to worthless and as a result the solvency of many of the world's largest banks became an issue. This time it was due to the collapse in the value of subprime mortgage-backed securities in the US; in 1982 it was due to the governments of developing countries defaulting on their external sovereign debt.



How the World Avoided a Second Great Depression: Or What Was Different from the 1930s?

- **Large fiscal and monetary expansions**
- **Aggressive and large interventions in financial markets**
- **The existence of a social welfare state limited the social & political consequences**
- **International financial institutions (IMF, WB, WTO, EBRD, OECD, etc) promoted cooperation instead of "beggar thy neighbor" conflict**

In many ways the financial "shock" that produced the current crisis was even greater than the shock that caused the Great Depression. Both crises resulted from roughly similar causes; those being global imbalances, rapid financial innovation, excessive credit creation and asset price bubbles. And

during the first year and a half of this crisis the declines in industrial production, trade and capital flows were even greater than what happened during the first year and a half of the Great Depression.

However, since April of this year the global economy appears to have stabilized, conditions in financial markets have improved, and the possibility of a complete economic collapse has diminished. So an obvious question is, what was different this time; in other words what turned this crisis around instead of allowing it to continue to worsen as in the 1930s?

I believe there are essentially 4 main reasons for this.

1) First was the macroeconomic policy response. Governments throughout the world implemented unprecedented monetary and fiscal expansions and addressed the collapse of the financial sectors very aggressively. During the 1930s the exact opposite happened; then, governments tightened monetary and fiscal policy. Governments then were worried about balanced budgets and maintaining their exchange rate pegs; this time they have given priority to resolving the crisis. Also many of the benefits of an expansionary policy leak out to other countries while the costs remain domestic, for this reason it is desirable to have an internationally coordinated response. This time unlike in the 1930s, there was considerable coordination amongst the world's economies, especially those in Europe.

The policy response to the crisis in the advanced and developing countries has been somewhat different and the nature of this difference has been somewhat surprising. Generally it has been argued over the last several decades that the amplitude of business cycles in emerging markets is greater than in the advanced economies; one important reason for this is that they are more constrained in implementing counter-cyclical macroeconomic policies. This is due to their greater need to maintain the confidence of financial markets. Thus one would have expected that in this crisis the discretionary fiscal expansions in the advanced economies would have been larger than in the emerging markets, but the opposite has been true. The average fiscal expansion was 3.7% of GDP in the advanced economies, 4.7% in the emerging economies and an even higher 5.8% in the transition economies of south-east Europe and the CIS. The fiscal expansions in the transition economies have been large because several of these governments (Azerbaijan, Kazakhstan, and Russia) had national stabilization funds (from energy exports) that could be tapped to finance their fiscal expansions.

In terms of monetary policy, interest rates were lowered to essentially zero throughout the advanced economies, and a number of emerging markets,

such as China, also flooded their markets with liquidity. In the 1930s many countries kept interest rates high in order to maintain their exchange rate pegs under the gold standard.

2) Governments in the advanced economies came to the aid of their banking systems which experienced systemic failures. These governments have committed resources equivalent to almost half of their GDPs for this purpose. In economies where the busting bubbles were particular large, Ireland and Iceland, this amounted to over 200% of GDP and in several others (Sweden, the UK, and the US) almost 100% of GDP. In the emerging markets, government support for financial sectors has been less needed and has thus been relatively small. In the 1930s governments experiencing banking failures were unable to fulfill their role as “lender of last resort” because they were on the gold standard.

These macroeconomic and financial market interventions will have some negative consequences in the coming years. Higher debt levels will have to be paid off and withdrawing the liquidity that has been created in the banking sector may prove problematic; increased inflation is another serious risk. However, these negatives are minor compared to what could have potentially occurred. **Bold government action was the key to keeping the world economy from falling off a cliff.**

In addition to the explicit government policy interventions, there were two other significant factors that played an important role in containing this crisis. These were the existence in the advanced economies of the social welfare state, and the existence of the international economic institutions; both of these of two institutional developments were created after the Second World War as a way to avoid the chaos that occurred in the 1930s.

3) In the 1930s the economic crisis created a humanitarian crisis as the unemployed became hungry and homeless. This led to social and political instability and ultimately World War II. The social welfare state has minimized significantly the negative personal repercussions of the current slowdown. Thus although unemployment is likely to reach 10% in many of the advanced economies, and this will produce hardship for some, the desperation of the 1930s is nonexistent. Politically, there has been no movement to extremist political parties. For example, the winners of the recent European elections were with only minor exceptions, tradition middle-of-the-road political parties.

4) Finally, the international institutions -- the IMF, WB, WTO, OECD, as well as regional ones such as EBRD played an important role in ensuring that we had international cooperation this time instead of the “beggar thy neighbor”

policies of the 1930s. During this crisis, the IMF was able to act as a global lender of last resort once the world's capital markets seized up; there was no global lender of last resort in the 1930s. Last year, when it was recognized that the resources for the IMF were insufficient, they were quadrupled to almost a trillion dollars. Protectionism has been kept in check by the disciplines of the WTO. Thus these institutions were able to play the critical role for which they had been designed.

A lot has been written about how this crisis was the result of policies based upon recent complex mathematical economic models that proved in retrospect to be quite unrealistic. There is much truth to that. The younger generation of macroeconomists bears much of the responsibility for this crisis. However, what is under-appreciated is that an earlier generation of economists – those that designed the Bretton Woods institutions and the social welfare state as well as those that developed the Keynesian logic of using expansionary macroeconomic policies to address recessions have been proven to have been remarkably insightful. The policy prescriptions and institutions they created after WWII essentially saved the world from the mistakes that were made by the current generation of economists and politicians.

The current economic situation

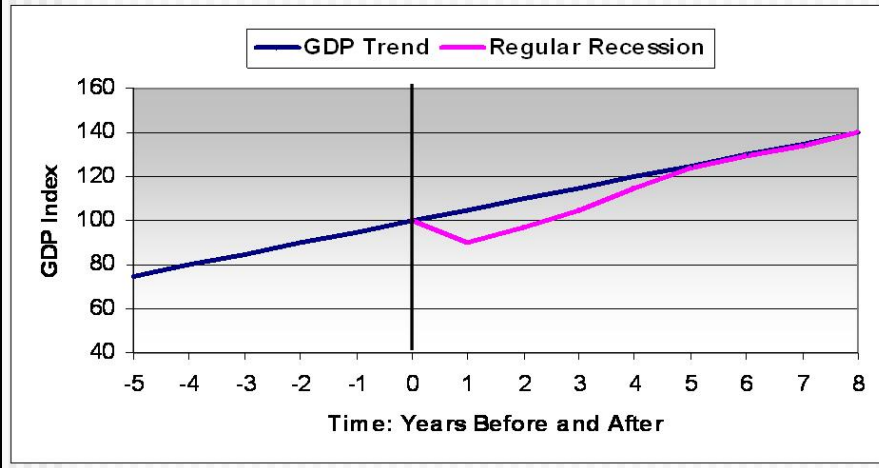
Let me now say a few things about where we are, and where we appear to be going.

The global economy has now stabilized. The free fall in the advanced and transition economies which occurred during the autumn of 2008 and the first quarter of 2009 has ended. The April 2, 2009 meeting of the G-20 in London probably marks the beginning of this stabilization. At that meeting it became clear that world leaders were prepared to do what was necessary to address the crisis. Several of their decisions, such as increasing the funding of the IMF were quite important.

What type of recovery can we expect? A number of researchers have studied the past experiences of countries experiencing financial or banking crises whose causes were similar to the current one. The one message that comes out of those studies is that recoveries tend to be slow and it often takes years to get back to the pre-crisis levels of economic activity and employment. In addition these crises appear to permanently lower the level of GDP.



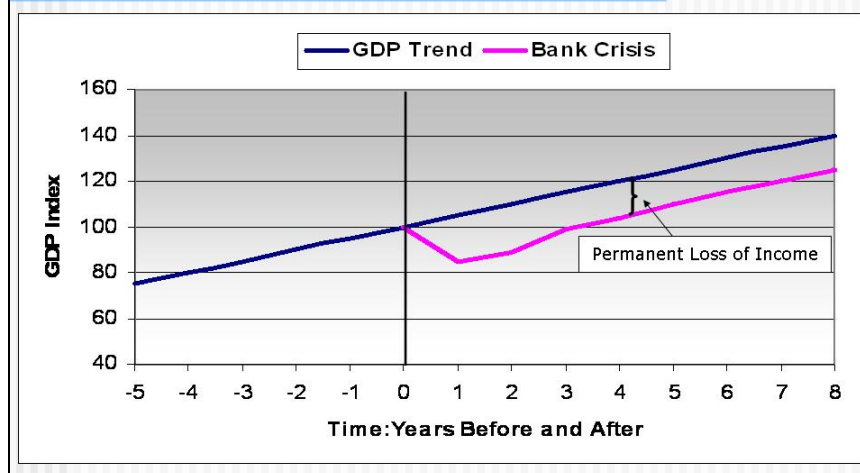
A Normal Recession Does Not Usually Result in a Medium-Run Decline in GDP



Let me explain. When one has a typical recession due to a monetary or spending shock, but not a banking crisis, it is followed by a robust recovery that allows GDP to bounce back and catch up to where it would have been. Thus in the graph when there is a recession at point 0, and GDP falls along the red line, but the recovery is strong enough so that after a few years we are back to where we would have been on the blue line which represents the normal growth path.

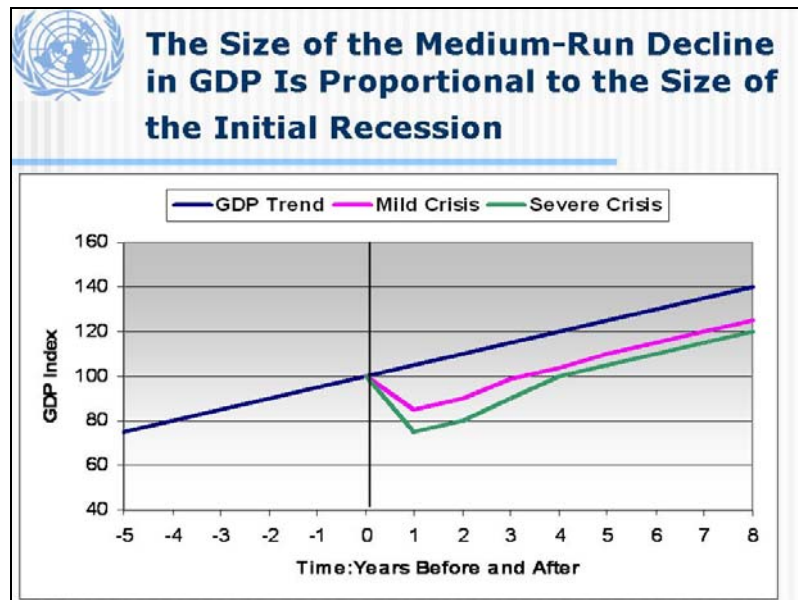


A Recession Caused by a Banking Crisis Results in a Medium-Run Decline GDP



Recessions caused by banking crises, like the current one, are fundamentally different. Instead of having a robust recovery which allows one to catch up to where you would have been, the recovery is weak and the level of

GDP is permanently lower, although the growth rate (which is the slope of the line) recovers to normal or long-term rate. Analysis shows that income is lower many years after a recession because both the capital stock and employment are lower than what they would have been.



In addition, the greater the initial fall in output, the larger the medium run fall in output. Based upon this analysis, the expectation would be that in the advanced and transition economies economic growth will remain subdued, unemployment will continue to rise, and the financial sector will remain dysfunctional for some time. And although the growth rate may return to its normal trend, the level of GDP may be permanently lower. The implication of this for some of the hardest hit countries, such as the Baltic economies, is not encouraging.

Will the Quicken Pace of Recovery of the Last 6 Months Continue? Answer: Probably Not

- Currently economies are being supported by extraordinary measures by governments
- The financial systems, although slowly improving, are likely to stay dysfunctional for some time (the issue is lending not solvency)
- Neither the consumer nor business is in a position to begin to spend; debt remains too high
- Unemployment is still rising; previous recoveries have been "jobless recoveries"
- Current strength is due to inventory cycle as firms restock since they no longer expect a depression

However, since the spring of this year, the recoveries around the world have been considerably more robust than the expected pessimistic scenario just described. Asia is growing rapidly and the recession is technically over in the US, France and Germany. Forward looking financial markets (which have appreciated 50%) have also priced in what would seem to be a fairly strong recovery.

So in the coming year, which is likely, a slow recovery consistent with historical experience or a continuation of the more rapid recovery of the last 6 months? That is the economic question of the day.

There are a number of reasons to believe that the recovery will ultimately prove to be slow and more drawn-out like the average historical experience; this type of recovery is usually referred to as a U-shaped recovery. Let me list the most important reasons.

1) Currently extraordinary measures are still being used to maintain aggregate demand. This includes large fiscal expansions which include a number of subsidy schemes for particular industries. For example, in the US and Europe, this includes the “cash for clunkers” car buying program or the US the large tax rebates currently being offered for home purchases. Monetary policy is still expansionary and interest rates are at the lowest rates in decades, or in the case of the UK in over 300 years. However, limits are being reached in terms of government debt and money creation in terms of what is viewed to be prudent, so there is pressure building to cut these back.

2) This was a recession produced by dysfunctional financial systems in the advanced economies. The good news is that the abnormally large spreads and volatility in equity, bond and foreign exchange markets has subsided. The bad news is that the banking systems in the US and western Europe are still under-capitalized and are still de-leveraging. Estimates are that, up to this point, banks have only written-off one-half of their expected losses. However, the problem of bank solvency which was a central concern 6 months ago has now declined, but there remains a problem of credit provision to the private sector which is still inadequate. Small and medium sized businesses which are dependent on bank lending will continue for some time to experience difficulty in obtaining finance. This will have potentially negative implications for investment by businesses, including of course for hotels and other tourist facilities. To fix these problems will take time.

3) The private sector, neither consumer nor business, has yet to demonstrate that they are ready to start spending again. Consumers have lost a

lot of wealth with the declines in house prices and stock markets. Consumer debt in some countries such as the US and UK remains too high. Thus consumers will be interested in saving for some time to restore some of this lost wealth. Unfortunately this is likely to have a particularly negative impact on tourism since it is a highly discretionary expenditure.

4) Unemployment is still rising, and consumers won't spend until they feel safe in their jobs. In addition, the first years of the last several recoveries have been characterized by being "jobless recoveries", and most considerations suggest that will be the case this time as well. Thus the high-spending consumer is unlikely to return in the near future.

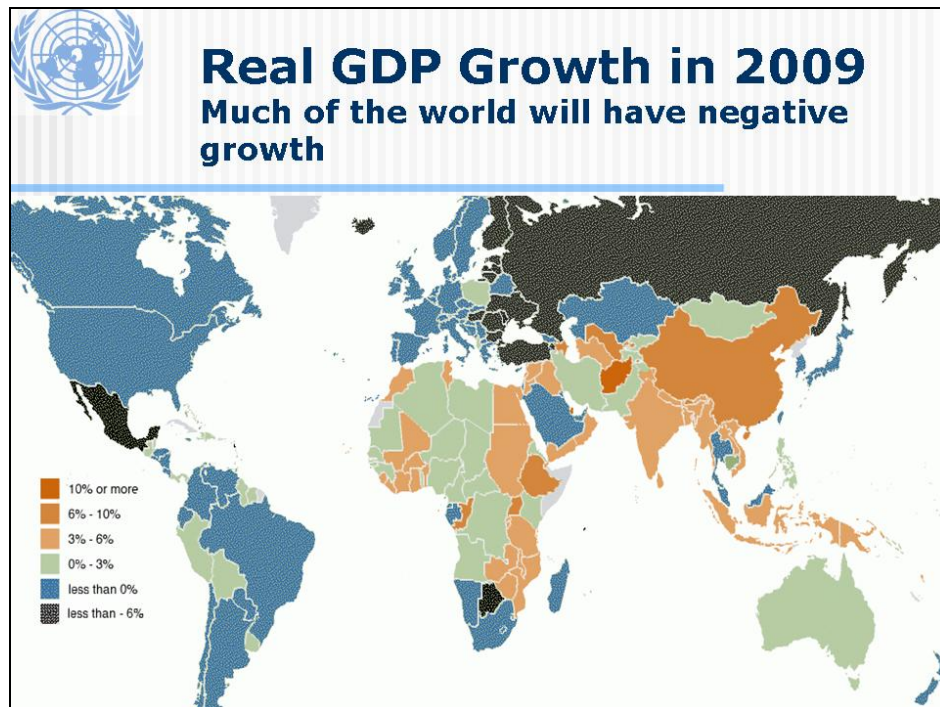
5) Some of the current strength in demand is due to the inventory cycle as firms had allowed stocks to fall to extremely low levels out of a fear that a depression was coming. That restocking may now have finished.

All these factors suggest that the current strength of the recovery may be due to temporary factors which may decline over time, and before the long-run fundamentals improve enough to carry the economy.

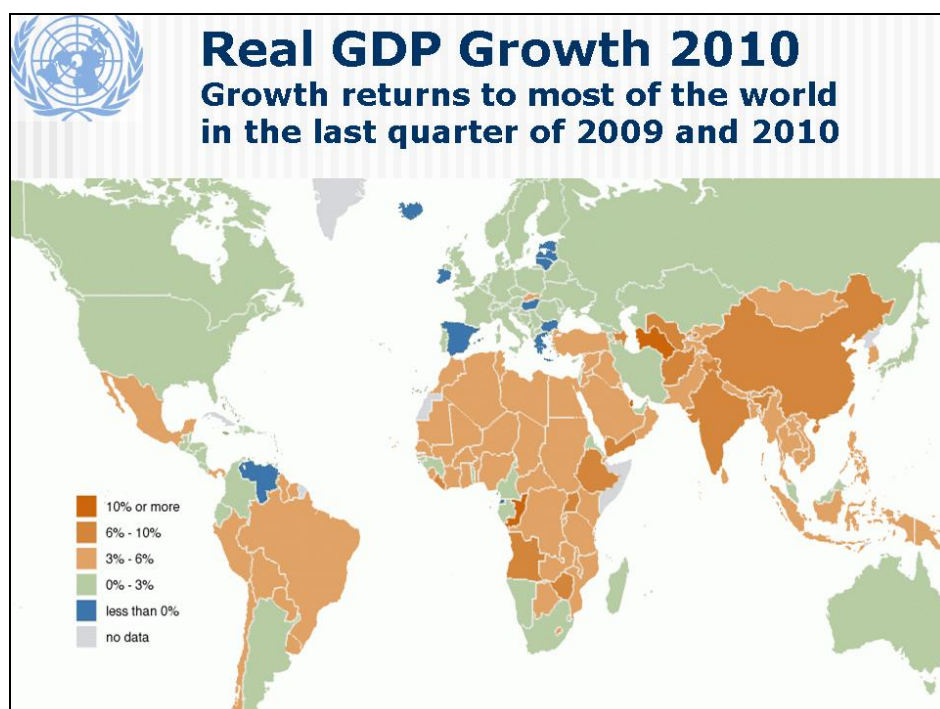
What is interesting about most of these factors is that they can be minimized by further economic growth. Thus economic growth itself can reduce unemployment, increase the desire for larger inventories, improve the solvency of the banking system, stabilize house prices, etc. There is in other words a virtuous cycle – growth leads to conditions allowing more growth. An interesting concept has been raised by US President Obama's economic advisor Larry Summers of whether the current stimulus can allow the economy to reach "escape velocity". In other words the current stimulus does not just allow us to hold on until the fundamentals improve, but may be capable of significantly affecting the fundamentals themselves. Thus the optimistic view is that the strong government-lead recovery we are now experiencing will feed on itself and create a strong private sector recovery. In this view the historical analysis may not be relevant because never before have governments attacked a financial crisis so aggressively.

The current economic outlook

As I mentioned earlier, the severity of the recession has varied significantly around the world. Although real growth in much of the world has been negative, it has remained robust in Asia and even in some parts of Africa. In Europe, Poland and Albania are the only countries likely to experience any growth in 2009.



By the last quarter of 2009 and 2010, growth returns to most of the world. Asia, Africa and parts of Latin America will begin to grow quite briskly. In Europe a few of the worst-hit economies, including Iceland, Ireland, Spain, Greece, and the Baltics may continue to stagnant.





The Recovery: More Specifics

- **Recovery will be slow in US & western Europe**
 - Unemployment may not reach pre-crisis levels until 2013
 - Business may face financing difficulties through 2010
 - Inflation will stay low
- **In eastern Europe, in some hard-hit economies (ie, Baltics) growth may not return until 2011**
- **Asia will have a robust recovery with little long-run consequences**

In the advanced economies unemployment may increase until mid-2010 and may not reach pre-crisis levels until 2013; financing will be difficult but inflation should stay low.

The policy agenda



The Next Policy Steps

- **Stay the course: avoid the premature exit of the 1930s & Japan in the 1990s**
- **But prepare an internationally coordinated exit strategy from stimulus programs**
- **Reform financial markets: this requires international cooperation and a significant degree of harmonization**
- **Address global imbalances; also emerging economies need to limit reliance on non-FDI external capital**

Given this situation, what is next on the policy agenda? Much of the discussion now is about the proper exit strategy. It is still too early to wind-down the stimulus programs, as there is no evidence the private sector can take over. History suggests that there is a tendency to reduce government stimulus programs prematurely over concerns about national debt. For example, this happened in the US in the 1930s and in Japan in the 1990s.

However, given some difficult issues surrounding implementing the phasing-out of these programs, it is not too early to begin to discuss and coordinate this exit strategy. I will not go into detail, but let me give you just one example. If countries begin to tighten monetary policy in an uncoordinated fashion, large interest rate differentials could develop which could result in large disruptive moves in exchange rates. So not only does the exit strategy need to be timed properly, but it must be internationally coordinated as well.

There has been a lot of discussion about how the regulatory framework for the financial sector should be reformed so as to avoid a repeat of the current crisis. This is an important subject, but I have avoided raising it since it is outside the core topic of this meeting. However, because this is an international forum, I would like to emphasize the importance of international cooperation in addressing this issue. Although there is general agreement on the main points, policy makers in different countries, because of different economic circumstances and different ideological beliefs, have come to different conclusions about the specifics. For example, the US has emphasized the importance of avoiding large global imbalances while China has stated that they think this is a minor issue. Continental Europe has wanted financial executive compensation to be given priority while the US has argued against government caps on salaries.

It is important to understand the predicament that policy makers are faced with in designing a new regulatory framework. The financial industry creates a lot of high-paying jobs and despite the problems that it has caused, it is still viewed to be a highly desirable industry for a country. At the same time the industry is very footloose and can easily move to locations with less burdensome regulations. Thus countries really do not have the option of unilaterally imposing the regulations that their policy-makers think would be most desirable. Countries realize that the regulatory framework must be agreed to internationally so that financial firms do not have the incentive of moving to less regulated locations. However this internationally agreed-to standard is not the one that the majority of the world's countries want or what the general consensus of expert opinion believes should be the standard. There is no international system of governance or more specifically a global financial regulator that can impose new regulations. Instead what we have is a international political system of decisions by consensus, and as a result the rules governing financial markets are those of the lowest common denominator. Thus it can be hoped that what really needs to be done can be done, but it is almost inevitable that the set of regulatory reforms that will be put forth will be far weaker than what would be optimal.

One of the basic underlying factors responsible for the current crisis was the large global imbalances that channeled excess savings from China to the US. In order to avoid a repeat of the current situation, this problem will need to be addressed. This will require an appreciation of the Chinese currency and a depreciation of the US dollar.

In addition, the severity of the crisis in eastern Europe and some of the other emerging markets was due to their large reliance on capital inflows in order to finance their economic development. This development strategy, which was similar to that of the south-east Asian economies in the 1990's, has now been shown to be unadvisable. Emerging countries in the future will need to rely on domestic savings and not capital inflows to finance their growth.

The crisis and tourism



The Crisis and Tourism

- **2010 will be a difficult year**
 - A more competitive cost-conscious environment
 - Trips: closer to home, shorter, less discretionary spending
 - Financing construction problematic
 - Oil prices will keep transport costs low
 - Government budgets will be tight
- **Longer-run consequences**
 - Destruction of \$50 trillion of wealth
 - Less vacation travel
 - Later retirements
 - Growth of middle income countries
 - Large middle classes who want to travel

I have tried to provide an overview of the economic situation and have left more specific comments about the tourism sector to the next speakers which have more expertise on this subject than I do. However, let me briefly note a few trends that are likely to follow from the economic outlook I have provided. Difficult times do not just mean less travel but also mean that travelers will be more cost conscious. Thus the types of trips chosen, their length, and the hotels and restaurants used will also change. Although interest rates will be low, banks are reluctant to lend and thus financing new projects or re-financing existing loans will be challenging. Lower oil prices should keep transport costs down. Large government deficits will mean that as time goes on public support for tourism activities and infrastructure may suffer.

In the medium-run, the destruction of so much wealth from the housing and equity busts means that older persons will be able to afford to travel less and may have to postpone retirements later. The continued rapid growth in Asia and some of the other emerging markets means that a new middle class of potential consumers is growing rapidly in these countries.



Key Objectives to Consider

- **Monitor latest economic trends & forecast so as to improve decision making of stakeholders**
 - Be flexible, adjust to new circumstances, look for new opportunities: slow recovery, destruction of wealth, financing difficulties, rising middle class in Asia
- **Be involved in the policy debates**
 - Determine what the tourism sector's interests are, and publicize how sector contributes to more general economic objectives; ie employment, foreign exchange
 - Ensure that the interests of the tourism sector are considered in policy initiatives & infrastructure projects
- **Keep focused on long-term objectives**
 - Economic development
 - Good jobs
 - Environmental objectives

Given this macroeconomic overview of the global situation, what should be done specifically for the tourism industry, either by governments, business associations or individual firms? In essence, what should be the concerns of a group such as this? After thinking about this and coming up with my list, I noticed that it was quite similar to the basic objectives already set out in the *Roadmap for Recovery* document created by the UN-WTO Secretariat. But let me mention three basic points.

1) There is a need to closely monitor economic trends and forecasts and provide this information to your stakeholders so as to improve their decision-making. This is what I have tried to do. As I have mentioned, there are some difficult times still ahead but there are new opportunities as well.

2) It is necessary to be engaged in the policy debates. As a basic principle, since this is a general financial and macroeconomic crisis, the solution should focus on fixing the financial system and addressing the recession through fiscal and monetary policy. Now there is an argument to be made for targeting assistance to a specific sector if it has been exceptionally affected, and it is believed that the large negative impact on this sector is going to be temporary. The automobile industry does appear to satisfy these criteria. A car purchase is fairly discretionary and can thus be put off for some time

during an economic downturn, and a high percentage of purchases rely on some form of financing which has been disrupted. Thus this sector was especially hard hit, and some type of special or sectoral assistance, such as the “cash for clunkers” programs might have been justified. However, for your typical industry special treatment is a kind of “beggar thy neighbor” policy where the neighbor is not another country but another industry. Do the characteristics of the tourism industry justify special treatment? This is an issue to be examined and hopefully one that will be discussed during this conference.

But within this larger policy framework, the industry needs to ensure that its interests are considered in formulating tax, subsidy and infrastructure projects. It is important to try to emphasize to policy makers some of the special characteristics of the industry, such as its ability to rapidly create employment or the contributions it makes to acquiring foreign exchange.

3) And finally, despite the challenges presented by this crisis, the industry must stay focused on long-term objectives. This includes ensuring that the industry promotes their country’s economic development, that it creates decent and well-paying jobs, and that it contributes to long-term problems such as climate change.