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Part of series	*The Credit Crunch and Global Recession*

Linda Yueh So let me welcome everyone to the third in a series of podcasts on the credit crunch and global recession. The format of this one will be different in that we've got a great group of students from St. Edmund Hall who are keenly interested in the issues and will participate in the discussion with the panel. We'll start off first with just introductions of the panellists before we ask Martin Slater to give us his take on the update on the credit crunch.

So first of all, I'm Linda Yueh. I'm a fellow in economics at St. Edmund Hall, University of Oxford, and today I'm going to serve as a bit of a moderator given that we have a great panel of participants this evening. So first I'll hand it over to Martin.

Martin Slater Right, thank you Linda. Yes, I'm Martin Slater. I'm also a Fellow in economics at St. Edmund Hall. At the very beginning of the academic year when the new freshers arrived in the college we did have a session on the credit crunch, which obviously at that time was really in one of its most dramatic stages. We explained that the crisis originally began to appear about a year before that time and general people tended to think about this as a crisis that was really to do with the sub-prime mortgage market in the United States, and that in the beginning people thought that it was relatively small but containable.

Towards the spring the markets tended to recover but gradually over the summer it became apparent that things hadn't mended themselves. And then towards September, then things began to get very dramatic indeed.

`[[All the time 0:01:44]]` stock-markets were falling very dramatically; through September, October stock-markets right across the world fell by 20, 30, 40% over those two months. And interest rates were falling very dramatically. There was some feeling at that point that after these, particularly the British bank bailout and the American bank bailout and the even passage through of the TARP, that maybe things had settled down a bit.

Well, what actually I think has happened is certainly that the fear of a comprehensive banking collapse had receded but that quite clearly didn't actually mean that the problem was over. And what we actually saw was that the pain began to shift to the real economy.

Largely up to that point, slightly strangely, I think in the view of most commentators, the pain had largely been confined to the financial markets, and the real economy had, to some extent, sailed on relatively regardless, until just about this time – September, October – when there were the beginnings of very sharp output falls all over the world.

And we can see that this has affected real firms. You can again set out a list of those. We have the American car makers who were obviously on the path to going insolvent before they were essentially bailed out. We've had a spate of bankruptcies in the British retail sector of which Woolworths is the biggest one, but many others. The third biggest chemical company in the world, Lyondell Basell, filed for bankruptcy in America.

So these are very sharp output falls. They are quite remarkably sharper than most people tend to think by experience in other recessions. So, what has happened since this kind of period?

We've had... clearly there have continued to be periodic financial wobbles but nothing totally as dramatic as happened in September and October. But it's been a period in which the banks have been caught in a difficult position. They've been trying to rebuild their balance sheets, to recover their reputations but they're also now beset, having originally been beset by bad assets as a result of the housing market, they're now also being beset by bad assets from the industrial sector as a result of this declining real economy problem.

In fact in particular, international lending between banks has been particularly drying up. One of the reasons for that is that the banks have been subject to conflicting pressures in this period. The governments who've bailed them out on the one hand want them to rebuild their balance sheets as fast as possible to recover confidence in the markets, and to repay the borrowing to the governments.

But equally the governments are wanting them to maintain their lending to the real sector to prevent this collapse in spending going any further. And of course those two objectives are fundamentally in conflict, and that is one of the problems we have.

You see, if the banks have recovered a certain amount of rather fragile equilibrium, the big worry that has begun to emerge as a result of this now is not simply whether the banks are insolvent, but whether governments themselves will become insolvent.

Because this process has essentially been one of transferring the burden of borrowing from private sector banks where we normally expect all these debts to be held, onto governments. Governments are essentially replacing a lot of the lending that used to be done by the private sector, partly indirectly through the governments, but also partly as one begins to see, there's a greater willingness of governments even to begin lending direct to private sector, real economy organisations.

So governments, as we know, are sort of piling up much bigger debt problems than they had hoped to do and there are worries about government insolvency. Clearly these are worries that most affect small countries. Again, top of the list you'll find countries like Iceland having a really torrid time of it. But equally even a country the size of the UK, question marks are being raised there.

It's also been an era where, if you've read the press, people are talking now about an era of unconventional monetary policy. In the US and in the UK, we now have interest rates that are already very close to zero. Not much in any way of getting down any further.

And this has worried people in that once they have got that far, they wonder whether there is any further traction on monetary policy. And it leads them into this idea that maybe one will have to do things that are rather unconventional. And these include a number of things.

One avenue is that central banks even consider lending direct, essentially, to the private sector. The American Central Bank is perfectly willing to lend on private sector paper. That, it would not normally have done. The other buzzword that you may have picked up on is a thing called 'quantitative easing.'

Well this is a technical jargon term, essentially for a form of expansion of the money supply. It is the modern equivalent, in the computer age essentially, of printing money. The authorities don't like to use that term for obvious reasons, but fundamentally they are trying to keep the money supply going up in various ways.

So that's monetary policy. Governments have also begun to think about the way in which we're going to expand demand by fiscal policy. In particular we see for instance a very big fiscal package currently being put together in America by the new Obama presidency.

So there is a kind of macro-economic policy theoretical issue of the balance of monetary policy and fiscal policy. It is increasingly being debated. The general view of economists is, I think, that for small fluctuations in past decades, monetary policy has essentially been the tool of choice.

If you see a little dip occurring you cut interest rates, you feed in liquidity. If you think that the economy is overheating you raise interest rates, you siphon out liquidity. And for relatively small adjustments that seems to work terribly well. Here we are in, as many people would say, relatively uncharted territory. This is a very big adjustment. Pulling all the monetary levers hasn't so far done the trick, and therefore the idea of fiscal policy which, of course, was a plank of good old-fashioned Keynesian economics, has become much more popular, much more topical, much more talked about by governments at the moment.

And so yes you will see that the media and politicians talk much more about Keynesianism than they used to. If you are a German finance minister you talk about 'crass Keynesianism.' Clearly there is a worry that governments are simply building up deficits, panic-striken in the short-run, which they will regret later.

The opposing view, obviously - which is one obviously held more by people like the UK and the US government - is that the situation is so serious that you have to contemplate debt levels that previously you would have preferred not to contemplate. And that is going to be necessary to get us out of this particular rut.

But that later on, there will be a problem, if we do get out of this rut. The problem will possibly very quickly change to one of trying to reverse these enormous stimuli that governments are putting in. Governments have put in an enormous amount of liquidity. They've put in an enormous amount of fiscal stimulus. Once this succeeds, and general history suggests that these kind of policies are very powerful in the long-run, but the lags are quite longish - monetary policy might have lags of two to three years before the full effects of interest-rate changes become apparent - and at that point, if the economy is really picking up, then of course there will be sudden shift in emphasis in policy that people will feel that a big inflationary stimulus has been unleashed and they've got to start extracting this liquidity and pulling back the fiscal stimulus. And that will be quite a difficult balancing act to carry off.

OK, so I think I've said enough for the moment so I shall hand back to Linda.

Linda Yueh Thanks, Martin. Before I turn to the other panellists to see if they have anything to add to what Martin has said, I suppose my adding to what Martin has said is just to give a bit of an update about what's happening in the US, and actually also what's happening to the UK on these two prongs of an attack as well.

As Martin says, there is a real economy affect, and then there is the financial crisis itself, so you see often-times it's being used interchangeably. This is a global financial crisis. It's a global economic crisis. And it is actually both. And it tends to be the case that when you have a financial crisis, an economic crisis will follow, because the banking system is the source of lending for homeowners, for borrowing, for what firms need to invest. So there is a direct link.

So in terms of what governments like the US are doing, is that they're still contemplating how to deal with the financial crisis. The talk now is that Obama has asked for the second tranche of the TARP plan to be released. So that's about $350 billion intended to address the financial crisis, looking at the troubled assets which are on the banks' balance sheets, and wondering how to get that off the balance sheets so that the banks can begin to lend per usual.

And the UK has already done it. Britain recently has, in a sense, injected a new round of liquidity into its banking system to help the banks recover their balance sheet positions, and they're doing this by asking the banks to ring-fence their troubled assets. So if they can ring-fence the troubled assets, then maybe there will be less uncertainty in the bank lending market – in their lending to each other- and that can get credit flowing again.

Another view, and that's been talked about in the US, is to create a 'bad bank,' an aggregator bank along the lines of the Swedish model where these troubled assets get put into a state bank and the banks therefore have clean sheets and they can start all over again.

And this is a current issue up for debate because the trouble with creating a 'bad bank' is how do you value the assets and how much is this going to cost the government to do this? Is it going to cost the government so much that public debt is going to cause a period of stagnation for these economies as a result going into the longer term? And the IMF has predicted that the amount of liabilities the British government is taking on as a result of its second round of bank injections of liquidity could cause it stagnate for several decades as a result of too high borrowing, therefore high interest rates in the future.

But the reason why this is so important is because unless you get the bank system lending again, any efforts to, let's say, stimulate the economy through monetary policy, requires the monetary transmission mechanism, which is interest rate policy working through the banks and then getting out to the real economy to actually work.

So if this credit system doesn't work then you could be in the case of, say, Japan, where the bad debts lingered on the balance sheets of the banks, and caused a decade, the last decade, of stagnation in the 1990's. So now you're probably thinking, this is either stagnation now or stagnation later!

But as Martin has already said, stagnation in the future possibly, there is a difference of opinion. And there's also a difference of opinion as to how to get lending going again now. Now the other big part about stimulating the real economy – I mean, in a sense the government is stepping in where the banking system is not doing the job of providing more liquidity so that firms can borrow and households can borrow. So a lot of the government's efforts in their various bailout packages is now directly injecting liquidity into, say, the commercial paper market, which what the United States has done.

And of course the other parts of it, of the stimulus package, which Obama's administration is pushing through Congress – this is the $800 billion package, is intended to provide tax-cuts. So it's supposed to increase your disposable income so people will spend more in the economy, and also to invest, if they invest in infrastructure. And again that will help firms invest and get the real economy going again on that basis.

But one big question is, will these stimulus packages work, if ultimately you still have bad debts lingering in the banking system, that's depressing confidence. And you end up in a downward spiral where confidence falls in the private sector because of the debts in the banks. The banks see that private businesses aren't doing very well. They don't want to lend to these businesses. And then, therefore, firms cut back and you get rising unemployment and you end up in a depression.

And so on that gloomy note I'm going to turn around to the other panellists. I'll ask them to introduce themselves first before they add what they would like.

Outi Aarnio I'm Outi Aarnio. I'm a lecturer in economics here at the St. Edmund Hall as well. Well, I agree quite with what Linda was saying about the worries that macro-economic policy makers must be going through now i.e. it seems indeed that the standard monetary policy transmission mechanism from lowering interest rates is not actually working. And the interesting thing for, of course US students is to think, what exactly is the part of the transmission mechanism that isn't working because of the credit crunch?

And, it is the first `[[stage 0:17:40]]` i.e. the central bank conducts monetary policy typically by, in a standard fashion, by lowering its own short-term interest rate which it borrows to banks and financial institutions.

Now, it is up to those institutions to obviously pass on this interest rate cut into market interest rates. It seems to me that that has effectively failed. Part of it, I think, is because of the requirement to recapitalise. i.e. you can't lend or wish to lend more, and lower your own interest rates, if you are intending to recapitalise, you are increasing your reserves and as a consequence of that market interest rates won't fall in the fashion we would expect in more normal circumstances i.e. when there are smaller fluctuations in output.

Now if monetary policy is actually failing to do that job the standard thing indeed is to turn to fiscal policy. Now, whether fiscal policy works... One reason why we, in the normal times i.e. during the past two decades or so, have actually abstained from using fiscal policy as an active measure i.e. fine tuning our economy through fiscal measures has been abstained by most governments – the reason is that there have been great doubts whether fiscal policies are actually effective when agents are forward looking.

Most of you should have – well first years perhaps not yet – have heard of a result called Ricardian equivalence... I don't see any heads nodding! No I see one! There are a number of third years here who should definitely know! I know what we do in the revision class. Well, if you would like to ask more about it we will perhaps come back to it.

I will hand it over to my left.

John Knight John Knight, Emeritus Fellow of the Hall, retired from teaching but not from economics. I suppose the key questions are: Will the stimulus package work? How much will it work? And how quickly will it work? And no amount of sophisticated forecasting is going to give us easy answers to these questions. We're in uncharted waters and this makes forecasting very difficult.

One of the problems is that there are important lags involved, and it's possible as Martin suggests that there will be no response, more and more stimulus, and then eventually the effects begin to flow through, and then we're in a completely different situation of which the problem is the fear of inflation rather than the fear of recession. But the crucial thing at present is there's been this incredibly sharp fall in demand and therefore in output, very recently.

If I were looking for other cases of this sort of thing, I think I would look to Japan. Japan had a financial bubble in the late 1980's, and this culminated in 1990 with a great financial crash. The Japanese economy had been very successful. It seemed to be in a process of cumulative causation, rapid growth, high confidence, high investment, continued rapid growth.

But after that financial bubble collapsed things changed enormously because the financial system was now looking very precarious indeed, and it was very difficult for the banks to lend. The government `[[tempered 0:21:31]]` monetary policy. It got interest rates right down. Monetary policy failed. It seemed to be a liquidity trap.

It tried fiscal stimulus and despite various attempts, wasn't very successful. And I think the reason was that the banks were in a bad state. And this has gone on throughout the 1990's and into the present decade. Japan now has much slower growth than it did in the past. I rather fear that one of the key things is to get the financial system efficient again, or more efficient than it is at present.

Linda Yueh The floor has opened. If you would like to ask a question – and just remember I am going to rephrase your question for the purposes of the microphone, not because we don't like the sound of your voice.

As with what happened in Japan, deflation became a concern when there was a bursting of the asset bubble. So John, do you see deflation as a possibility in this economic crisis?

John Knight Well it depends how you define deflation. Deflation is sometimes defined as a fall in demand, and occasionally, I think various journalists are using the term, to mean a fall in prices. Negative inflation... if we treat it as negative inflation, then it would be very unusual but it has happened in the Japanese case. It's possible.

One of the considerations will be primary commodities, and what happens to primary commodities. The primary commodity prices have been falling recently, after the great primary commodity boom of 2007. And I think, if primary commodities fall this would be one possible way in which prices did begin to fall. The other is, if you have a flexible labour market and wages fall in response to higher employment, that depends on the degree of flexibility in different national labour markets. I would be surprised if there was a general phenomenon of falling prices, but it is possible in some countries.

Martin Slater Yes, I mean if you look back into the 1920's and 30's in the UK, you did indeed have years in which prices went up and prices went down. So that's the kind of deflation and particularly after the end of the First World War, when there had been an inflationary process during the First World War, and government policies tended to want to get price levels back to where they were before the First World War – this was a doomed attempt, but they did try – and there was a period in which prices did indeed fall steadily for a bit. This indeed was the process that produced a great deal of industrial unrest and ultimately the Great Strike in 1926.

But, one of the things that does actually limit, in an economy like ours, the extent to which you get a really significant deflation, is what, going back into Keynsian economics, we used to call 'money-wage stickiness.'

Yes, commodity prices do have quite an important impact into prices, but in our economy the main determinant of costs is money-wages. Now, if the labour force is very reluctant to accept money-wage cuts, which traditionally has been the case, then that's something that really puts a floor on the way in which prices can fall.

But, of course, over the last couple of decades, we've had rather more flexible labour markets. And of course, you may have picked up writings in the press where you see that certain groups of workers have agreed wage cuts. Now if that actually gets going then yes, there is no kind of stickiness in the overall price level. So, it's possible.

The other kind of impact on inflation of course, in a country like the UK, is the exchange rate. Recently the exchange rate has been falling and that will mean that import prices in sterling terms will go up. So if the exchange rate continues to fall, that will be something which would tend to put a break on deflation.

Linda Yueh So in that sense perhaps, we don't have to worry about what happened in Japan happening to the UK. Because it certainly was the case that Japan was stuck in a deflationary spiral, and it's the classic example of the Keynsian liquidity trap which most economists thought was theoretical until it happened in Japan where the LM curve, your money... the reaction of money to interest rates was essentially flat.

Why that's so damaging in Japan and why it's so damaging in a crisis is because if you have high levels of indebtedness and you're asking your banks, your firms, your consumers as in the US and the UK, to deleverage, get rid of the debts, having falling prices increases the real value of indebtedness and it makes the deleveraging process much more painful.

But the UK is braced for it, although I tend to agree it's unlikely to happen. The UK is braced for it in that Paul Tucker at the Bank of England just a few weeks ago said that the Bank of England was ready to use quantitative easing when nominal interest rates fall to zero. And British interest rates are at 1.5%. It's already negative real interest rates if you consider that inflation is around 3%. So that means that they will print money, and that is in reaction to the fact that they don't want to be trapped in a deflationary downturn.

But expectations make all the difference as to whether or not that kind of measure will work. And in Japan it didn't work. People's expectations never changed just with the use of quantitative easing. And in fact Japan abandoned it around 2006.

But there's another side to this inflation expectations. If the public thinks the government is doing this to pay off the £trillion of debt being borrowed in order to pay for the fiscal stimulus packages and the banking bailouts, then they might think – 'Oh this looks like seigniorage', the process by which the governments print money, impose an inflation tax on savers, transferring essentially real value to borrowers and those who are indebted. And when this happened in Latin America inflation became hyperinflation and the system became very unstable. So what you essentially have is price instability, and that could go both ways, depending a great deal on expectations.

The question is; Taiwan has introduced a consumption voucher scheme, and what the impact of that is likely to be.

Next question.

Outi Aarnio If I recall correctly Japan is a similar sort of thing i.e. the idea is that if consumer confidence is very, very poor – that is to say you give them the tax cut – that has to with ricardian equivalence, they actually save it because they expect future tax rises. Now if you give them, instead of tax cuts, a voucher which says that you spend this by 31st March, the tax cut comes with a condition which actually would boost consumption. I don't know whether it was large scale enough in Japan to have any impact but clearly one would imagine that most people would spend it. Though it was attached I think, to spend it on children. It was given for families with children and so on. So I'm not sure of the extent of the scheme and whether it actually worked. But yes, that would be a possible solution to the ricardian equivalence problem.

Martin Slater Yes, there's an interesting parallel in the UK, not a consumption voucher at all but you remember the government implemented a temporary cut in VAT, which of course has come into a lot of criticism, in fact. I'm personally not so critical of this but it has... one of the effects of this is that it has this kind of effects. Because, since this is purely a temporary cut in VAT, what it suggests to consumers is, as we get nearer the time when it's going to be restored, then if you're going to take advantage of it, you're going to have to spend now you see, rather than save it.

So there is some argument in favour of some kind of time-dependent stimulus that does indeed sort of get people spending now, and defeats this very rational incentive that of course, if you give people money at a time when you're telling them that the environment is incredibly doom-laden and they've got a very high probability of being out of a job in the next six months, then not surprisingly they're going to tend to save it.

And that applies to individuals. It applies to the banks. It applies to companies.

Linda Yueh Just to add to that. The VAT cut of 2.5% was only meant to take effect in 2009. Similar measures were taken to, say, temporarily suspend stamp duty. So it's an attempt to influence our consumption patterns by moving it into the year in which the economic recession is expected to be the worst.

But the big problem with all of these measures including in Japan and possibly what we'll face in the UK, is the bill for this very small VAT cut of 2.5% is estimated to be £12 billion. Under normal budgetary conditions, that's about a third of what the British government borrows every year in normal times. So are you going to get enough of a boost to the economy for the kind of money that you're spending? And if you look at Japan, their debt to GDP ratio is 200%.

All of these unconventional policies, including unconventional monetary policies, have a very heavy cost associated with them, and that's I think the criticism that's come from the Conservatives over the government's VAT cut policy. So the question is, is the VAT cut enough of a cut when high street stores are cutting prices by much greater percentages than 2.5%? So is it the right policy? Is it the right way to spend the money when the government could be spending it on bailouts?

I'll say one word on it and then turn over to the other panellists. The reason why VAT was cut from 17.5% to 15% is that the European Union has a requirement that VAT not fall below 15% for its member states. But perhaps given that the UK is going to more than triple its budget deficit to GDP ratio to 8%, well above the 3% recommended by the Maastricht Treaty, and since they've suspended a lot of rules already for countries like Germany and France in this crisis, perhaps the VAT is another one that might want to go.

Martin Slater Well, yes. A lot of the criticism focuses on what you've just said. That when retailers are cutting prices by 25%, 30%, does an extra 2.5% make much difference? Well, that's fair enough, but look at it another way.

At the end of the day, the effect of the government not taking £12 billion in VAT means that either private individuals' or firms' balance sheets will be better off by £12 billion. And that's one of the things we want to achieve.

So we have this conflicting objective. We must get in the long-term the balance sheets of the private sector improved. That, unfortunately conflicts with our objective of keeping them spending at a rate which is going to produce something with is tolerably close to full employment. So anything that at the end of the day means that your balance sheets are better off is advantageous.

Now, it could've been targeted slightly better, I think. But any kind of fiscal stimulus will have that effect.

Linda Yueh You want to follow up? I think of the question that has just been asked because a very cleverly worded question, we sometimes expect from students.

So in a sense, the argument you're making in the question is that the VAT cut will improve balance sheets at the private sector by £12 billion that otherwise would've gone to government coffers, is directly impacting the health of private enterprises and private consumers which, at least on the enterprise's side, would mean they would become slightly better as the banks consider lending to them.

Whereas, if their businesses look very dire, then perhaps no amount of cajoling would get banks to lend to them, and then therefore this might be another way of trying to get the economy going again.

John Knight As a result of the reduction in VAT, real income rises by a couple of percentage points. The problem is that consumption is a function of a good deal more than income at a time like this. It depends also on what people expect prices to do. Are they going to be rising or falling? Are they going to be lower in the future? It depends also on whether people feel increasingly insecure, in which case, better save. It depends on what's happening to the price of people's assets. Is the price of their assets falling? In which case they feel poorer and therefore they feel they've got to save more.

But there might be quite a number of things going on which encourage people to save even though there is this increase in real income which in theory, ought to increase their consumption.

Linda Yueh And I suppose, it reminds me of another point about the banks that I thought might be good to raise, which is: about half of the lending in the British economy comes from foreign banks and financial institutions, and that has pretty much withdrawn from the UK market as a result of the global financial crisis. So the British banks are now asked to maintain the volume of lending to 2007 levels.

But they're asked to recapitalise themselves, improve their balance sheets, but also make up for a shortfall in the lending in the domestic economy as a result of the withdrawal of banks. For instance, from Iceland.

And so, this makes their challenge much worse than perhaps if it was just the case they were asked to resume normal practises under other circumstances. The question is, to what extent are these crises a function of expectations and confidence? And to what extent are they the result of numbers? And how can the government address it?

Martin Slater Well I'm not sure that they're one or the other, in a sense. I presume by "numbers" you mean some kind of objective fundamentals are wrong with the economy. I think it's about both. Expectations don't always reflect fundamentals truly, and yes clearly expectations can diverge in both directions. But what we certainly have here is a serious collapse in expectations. Why? Well, not an irrational collapse in expectations.

Clearly, a lot of very dodgy assets were allowed to accumulate. And when people finally woke up to that fact, and it wasn't an easy kind of process, I think, to identify that fact, then it's quite rational that people should lose confidence in the banks. You know, let's go back to that very dramatic time in September/October, and these days no doubt you've seen whose on the television when people say, "At a particular time the UK banking system was within hours of complete collapse. The major high-street banks would not be able to open their doors." It's not surprising that that, which was an objective fact, has fed into people's expectations.

Linda Yueh How long do you think it will be before the UK experiences consecutive quarters of positive growth? And will we see house prices rise first?

John Knight There are economists who don't know, and there are economists who know they don't know.

Linda Yueh As an attempt to answer your question, I can give you historical patterns of what's happened but let's first say that this crisis – this particular crisis and the extent of the financial sector problems – is reminiscent of the 1930's, making the patterns that I'm going to give you, on average coming from the post-war period, probably to be rather poor guides.

So in the UK, on average in the post-war period, recessions had five consecutive quarters of negative growth, and the latest statistics suggest that the UK had 0% growth in the second quarter of 2008, and -0.6% growth in the third quarter, and -1.5% in the fourth quarter, meaning that we are at least two quarters into the recession. So if things were normal, under normal recessionary times, we might expect a turnaround by, say, the fourth quarter of 2009. But these are not normal times. And in terms of asset prices, after a financial crisis asset prices actually fall for much longer than GDP falls. So in research done by Ken Rogoff he's found that on average asset prices, stock markets and housing fall on average between 3-5 years after a large scale financial crisis. So that doesn't bode particularly well for the housing market.

But I should qualify that to say their study also encompassed developing countries for whom the average recession after a crisis, or just recessions in general, are much longer than what they are for the West. So developed economies do recover faster even after a major financial crisis and the UK is testament to that, because after the ERM crash out of sterling, the recovery was much faster after that crisis than if you compared it to say, the Asian financial crisis in the late 1990's for which it took those economies about until 2002 before they began to see positive asset flows. Anyone else want to venture a... `[[Crosstalk 0:41:33.1]]`.

Outi Aarnio A few numbers. The last two recessions, early 1980's and early 1990's, UK GDP growth fell about 1 year, less than 2%. The latest predictions in today's newspapers are that GDP growth will be negative, year on year, over 2% this time.

So basically we are saying already that this one will be severe. I mean, the best economists that this one will be more severe than we have `[[had before 0:42:10]]`. Well in the last recessions unemployment rose to 3 million people. So the prediction that we end up this year with

3 million people unemployed is probably an underestimate, if we look at it based on the historical experience of what happens.

Martin Slater But one obvious lesson of the past couple of years is that all the economic forecasts have been very unreliable. And that's no surprise to economists. I think most serious economists know that the track record of economic forecasting is not very good. What happens in the economic forecasting industry is that there tends to be a convergence of opinion to the current consensus. Each economic forecaster does not want to be out on his own or her own, and therefore what you see is the current consensus.

As I said, 18 months ago the current consensus was that this was a relatively small problem which could be contained and people said, well there would be a small dip and we would be back into growth by now. As things got a bit worse, lo and behold the forecasters said, "Things are going to be a bit worse! And maybe it will take two or three more quarters." Now we're really into, sort of, doom and gloom and it's going to take a long time. It's quite possible that they'll be wrong again.

And I think the lesson of this is really, and I think the lesson that a lot of people are beginning to see is that the real thing is that people should not believe too strongly in one particular scenario. That's what got the banks into this problem in the first place. They really believed their models and they should really have understood that their models were pretty good but you know, they weren't perfect, and there were situations that they would find that their models really fell apart in. That's quite a strong theme I think.

So, certainly at the moment the current view is that. But as you can see people's views have changed very dramatically very quickly and they will no doubt change again.

Linda Yueh This reminds me of something one of our colleagues David Hendry has said. He's an economic forecaster, as you know, at the university. And he always says, "The best forecasters tell you what happened today."

So the question is, is there a problem of government insolvency? In particular looking at the very different fates of the European Union whereby countries like Spain and Greece are borrowing at around 5.5% whereas countries like Germany are borrowing at around 3%. Is it the case that now particularly in the Eurozone they don't have the exchange rate as an additional mechanism? What's likely to happen to their solvency positions?

Martin Slater Well, yes – this is a very good question. I think...

Linda Yueh As are the others!

Martin Slater I think honestly, again, we're talking about uncharted territory. Nobody quite knows what would happen. When the Euro was set up, this was indeed one of the problems that people thought was going to be significant, and the structure of the Eurozone. The solution to this was of course the Macro-economic Stability Pact, which essentially said no governments would not be allowed to borrow beyond a certain limit because otherwise there would be this problem of, sort of relatively weak governments being able to use the credibility of the Euro to borrow, get themselves into bad indebtedness positions, get into this spiral, not be able to bail themselves out. What would happen?

I suppose what happens in parallel in banking markets when people `[[get into debt 0:46:38]]`. Well, the ideal thing of course which we've seen hasn't worked entirely this time is that the central bank gets together and twists the arm of the stronger bank to take over the weaker bank and quietly solve the problem behind closed doors.

Now, politically that's possible, and that's what you were hinting at. Maybe what'll have to happen if say, somebody like Greece or Ireland really gets into a problem, the stronger countries like Germany and France are simply going to have to sort of, bail them out. And of course this will not be very popular with Germany and France. It will not be popular with German and French taxpayers and will put a lot of political stress on it.

Other people have said, “Well maybe the solution is that some of these countries will have to leave the Euro.” Well, institutionally that, too is rather difficult to see how that can actually happen. Yes, it does happen occasionally. People have to completely reconstruct their currencies. But obviously the whole business of going into the Euro in the first place, most countries had run down their independent monetary authorities and so this would be very difficult thing.

So yes, it’s a very unstable situation. Nobody knows what would happen. They hope it’s not going to occur. But as you can see, sometimes the unthinkable does occur. What happens when we get a type of problem like Lehman Brothers.

Outi Aarnio I have a comment on this.

Martin Slater Actually you know – just says, “We can’t deal with it!” and just throw it up in the air and something totally unexpected will happen. And that I think is clearly what the Euro countries want to avoid. But of course their macro-economic stability pact is all very well but as you all perfectly said at the time, it just does not have credibility against if a country is really in terrible political difficulties, they’ve got political financial difficulties, they’re not going to be able to resist the political pressures to continue to borrow.

Outi Aarnio When the `[[Grossen 0:49:13]]` Stability Pact was put together, there was another worry: an externality i.e. when you have in the monetary union weak countries, i.e. in a bad debt position and so on, they can free-ride on the reputation of Germany and so on, i.e. there’s going to be a bailout, which would then reflect an externality i.e. the whole Eurozone would face high interest rates.

Now your example shows us that financial markets are sophisticated enough to differentiate between Greece and Germany. Well, what might then happen is that you could, for instance, you might force Greece to borrow from outside the EU.

Go to the IMF if you want the bailout, just like Iceland. It doesn’t have to be us. So the one worry that financial markets would actually push interest rates up for every European country obviously hasn’t materialised in the extreme. Well, that’s sort of – it’s quite interesting actually because that was a big worry.

Linda Yueh I think the PIGS economies, (Portugal, Italy, Greece and Spain) did very well in the early part of the Euro. I remember the southern expansion in 1980 suddenly made the southern European countries very fast growing but as a result of course, they’ve had a huge housing bubble and massive asset prices, especially in Spain and in Portugal.

For them to get out of the Euro would mean probably their situation would be much worse. So if you look at other countries which are not Eurozone countries, in Scandinavia for instance, they’re finding this crisis means that their currency has lost so much value that they’re worse off by not being a part of say, the Eurozone. And in fact what this crisis has done is to make the Eurozone more attractive to small economies like Iceland, had Iceland been in the Eurozone. I dread to think what would happen! But it’s actually changed, I think, the Euro debate.

In order for these governments to pay for the debt they’re going to have incur to either stimulate their economy or bail out their financial sector means issuing trillions of dollars of government debt. So the United States dollar is viewed as a reserve currency, a safe haven, so people still demand it even when interest rates fall. The Eurozone has actually held up. The Euro itself has held up fairly well because there is still a strong belief the Euro will be there, and you can contrast that to, even what’s happening with sterling, to show that if you are a country, you’re not a reserve currency and you don't have a large, perhaps a single market attached to it, then your currency is going to be much more vulnerable and making your borrowing even harder if other investors in countries aren't willing to buy your sovereign debt. And that means that it has a lot of implications for the sustainability of what's going on at the moment.

Outi Aarnio I have a solution for the Icelandic problem. Let the Norwegian sovereign fund buy them up!

Linda Yueh I think they wanted Russia to buy them up! The question is then, we've overlooked the beneficial effects of a weak currency and discussing the relative weakness of the sterling relative to the euro.

Outi Aarnio Oh yes. In principle that should work. Of course it depends on how bad the demand is in foreign countries who are supposed to buy our goods `[[effectively 0:52:39]]`. So a falling sterling in principle should boost our position. The problem may be the structure of the British economy i.e. the small share of manufacturing. And that in fact, where Britain has had in recent years a trade surplus, is in services. Financial services... a little bit perhaps in the music industry and that sort of thing. But it's the financial services which have created the surplus so the demand for the British financial services might not actually be buoyant at the moment despite sterling falling.

Linda Yueh I think it is an important point and I think in order to assess it we have to think; Is it this recession more like the 1980's or the 1990's? If it's a global recession alongside a domestic recession then it's more like the 1980's and global demand is falling such that exports are likely to become a big driver even if the currency is cheap.

So to give an example, manufacturing firms account for about 15% of British GDP. In the 1990's recession they experienced an output fall during the entire recession of 8%. And the reason for that is because they were growing via exports even as the domestic market was contracting. In this recession manufacturing has already fallen 8% and the recession has just started. And the reason is in part because global demand is contracting. This'll be the first year since 1982 where the volume of global trade is expected to contract. So the currency might be cheap but as Outi Aarnio said, who will you sell it to?

Martin Slater I think in principle you're right. No currency is arrangement is uniquely good. Each currency arrangement has some advantages and some disadvantages. Also the advantage that UK has had so far, also is that is has been able to control its own interest rate, unlike other European countries. So we have in fact used that freedom to push our interest rates down before the Europeans did. And of course this goes back to the general debates about sterling and the Euro – that the problem about a currency union is of course, that there is a single monetary policy for all.

Another interesting statistic I picked up which you should note. Unemployment in Germany only began to rise last quarter. All through this year of crisis, unemployment in Germany has not risen until very recently. Which of course explains why the German government and consequently through its influences on the European Central Bank, they have tended to take the rather more conservative view to monetary panic, saying "yes, we will not be panicked into cutting interest rates."

So given that the real economy in the Eurozone area seems to be moving on a trajectory which is a bit behind our trajectory, then it has been advantageous that British monetary policy has been able to move rather faster. But equally we have the disadvantage that we're a bit more vulnerable because we don't have the stability of size against circulation when confidence begins to get nerves.

Linda Yueh The question is, although I don't know if there will be an answer... the panel has been asked if we had to take a long or a short position on an asset or a currency or some type of stock... any basically, any bets in this global economic climate, what would it be?

Martin Slater Well, economists are not very good at picking stocks.

Outi Aarnio I have an answer... Cash.

Martin Slater Well also, a lot depends on your time horizon. If I'm thinking rather longer term I would be rather more concerned about inflation than people would be if you were holding some asset just for the next six months or twelve months.

So I don't think there's a single answer to that. Also I think that although the efficient market hypothesis has come in for a lot of stick in the past, and I think nobody these days would put their hand up and say markets are perfectly efficient. Markets still have one of the properties of efficient markets and that is that it is impossible generally speaking to have a rule that is guaranteed to work. There's a very interesting article by `[[Bob Schiller 0:58:09]]` back in the 1980's where he talks about this. I think it should be more widely known.

The interesting property about an efficient market is that an efficient market should track the real economy properly so that it wouldn't have great errors, but it also should track it in a way that in a sense, damps down the current moves in real activity. What `[[Bob Schiller 0:58:38]]` showed in this article was that, yes, the stock market does tend to track the real economy with an unbiased error. But does it damp it down? No. It actually has a volatility which is about thirteen times as big as the underlying volatility which it's trying to follow. So basically yes, nobody can have a system to beat the market, but that doesn't necessarily mean that the market is a terribly good efficient thing for economics.

Linda Yueh Anyone else want to give any stock tips? John?

John Knight Well there is a tendency for expectations to be infectious. And when people get gloomy they all get gloomy and sometimes they get over-gloomy. At some point or other I suspect that stock prices will be undervalued. The question is when. And I want to decide that.

I suppose another very important issue is the dollar. If we look at imbalances in international payments, one of the most remarkable imbalances is between on one hand, the United States and also Britain, and on the other hand the East Asian countries. China, Japan. China and Japan have been running large current account surpluses.

In the Chinese case it has been near 10% GDP and in the US case and British case a considerable portion of GDP current account deficit. This has been possible because the East Asian central banks have been willing to lend to the US, to Britain to some extent, and this has enabled the US to run low interest rates, and has contributed in fact to the financial bubble which recently burst. I'm not at all certain what the outcome is going to be. I had rather thought that at some stage there would be a great run against the dollar. It hasn't happened and I think in times of great uncertainty and fear the dollar seems safe. The major currencies seem safe. In fact the dollar has risen against some currencies like the pound.

At some stage or other there will have to be a realignment between, shall we say, the dollar and the renminbi, the Chinese currency. The Chinese view is that they have tied the renminbi to the dollar, on the grounds that at the going sort of rate, they've been able to expand their exports very well and this has contributed to their very rapid growth. However, there's been pressure on the Chinese to up-value, and over the last five years or so they have up-valued at about 5% per annum. They've been resisting to up-valuing more recently although up until very recently, their exports have expanded very fast and their current account surplus has not fallen as a proportion of GDP. Indeed it's risen.

So there is this huge imbalance in international payments. It can't go on indefinitely. There's going to be an endgame but it's not at all clear to me how it will happen and what form it will take.

Linda Yueh For more advice not to be relied on, is that not all industries actually do badly in a recession. So the sectors which are expanding are supermarkets. They're expanding employment at ASDA and they're selling lots because these are necessities and so they actually tend to do pretty well in a downturn.

Outi Aarnio `[[Domino's Pizza 1:02:42]]` (Laughter)

Linda Yueh But don't rely on this for investment advice. Last question for Andy. I somewhat take issue with the phrasing of the question. I'll still repeat it.

The question is: Professor Knight has stated that the Chinese have purposely lent to the United States at cheap rates and contributed to the global imbalance. Is this a deliberate manoeuvre to shift economic power from West to East? I will come back on it as well!

John Knight My suspicion is that the Chinese government's main objective is rapid economic growth. It sees rapid economic growth as very important to the Chinese people and very important to the government in that it keeps it stable and secure in power. So the exchange rate policy which they have pursued has been an attempt to promote economic growth, rather than in terms of international relations.

Linda Yueh Okay, I'm going to give my take on this which is that it's undoubtedly true that one of the causes of the current financial crisis is how cheap lending has been. So of course banks didn't properly assess the risk. Regulators didn't monitor what the banks, financial institutions were doing, particular the shadow financial system. We've talked about misaligned incentives of bankers.

But one of the reasons why this will – the macro-economic context also matters – one of the reasons why this was possible was because the United States was drawing on global savings. And the savings have come from, in a sense, countries with current account surpluses, either because they have a natural resource like oil. So the middle eastern oil exporters also run large trade surpluses with America, and of course east Asia. China, Japan, South Korea, Taiwan, all run large trade surpluses, meaning that they, in a sense, fuelled US borrowing by … they fuelled US borrowing in a couple of ways.

The main way is of course, that when you have this kind of surplus you accumulate foreign exchange reserves. These countries also ran fixed exchange rates with the dollar. So regardless of the value of the dollar they are likely to put their money into dollar assets. And by doing that they push down interest rates, including in the longer run, making borrowing cheap in America.

And the other way they do it is that, if you look at the declining savings rate in the United States – it's fallen dramatically over the last two decades – you might then wonder how is it possible for a country with such low savings to actually borrow so cheaply?

Well, the reason is because they're borrowing globally, and so it enables the Americans to consume. But the causation here is difficult. Is it because the Americans consume too much, or is it because the Chinese save too much? And these are macro-economic identities, both of which are true.

So thinking about how that's influenced the crisis; was it deliberate? I don't think you necessarily can deliberately manipulate US consumers to consume too much. And certainly the Chinese government hasn't – I mean there is a problem with Chinese consumption but it's an institutional problem. The reason why Chinese consumption rates are low – and Chinese consumption rates have actually fallen in the past decade while growth was at 10%, which is very unusual.

Consumption used to be 50% of GDP. It's now fallen to about – household savings has fallen to about a quarter. And this is in reaction to the fact that spending on social security has actually fallen over the past decade, meaning people need to save more.

So it's this type of different determinants which has contributed to the crisis. So I think the Chinese would not want too much attention to shift to them at this moment. I don't think they want to be powerful and a leader out of this financial crisis, and the comments of the Chinese premier [[?? 1:06:47]] strongly indicate that they see this as a US problem which then spread into Europe because Europe in around 2000 allowed its banks to borrow on US wholesale money markets. And it's not a Chinese problem. That's not entirely true either, but never mind.

As Chinese consumption has fallen and the Chinese economy has relied on exports, does this crisis mean that Chinese consumption must rise?

I think the answer to that is yes. Exports contribute about 25% of Chinese GDP growth. But the question is can domestic demand make up for that amount of fall? And the latest statistics out of China suggest that it can't. And the reason is because the drivers of domestic consumption in China are longer term behavioural problems – issues like the lack of a social safety net. That doesn't get turned around very quickly, but where the Chinese can influence domestic demand is via investment and if you look at the skill of their physical stimulus package it is much larger than any other countries. It's 15% of GDP over two years. The United States injected about 1.5% of GDP. Britain injected £20 billion, less than 1% of GDP. The European Union wants its members to inject 1.5% of EU GDP.

So compare that to the Chinese 15% and China is the size of Germany in terms of its economy – you can see how much effort they're putting in to try to get domestic demand going.

But I'm always an optimist. What this crisis shows is that even though it was very easy to sell to Western consumers, it's not a sustainable model, and the cheap currency has depressed consumption at home by making imports very expensive and perhaps this is a turning point in which China can get its consumption rate up above 50%. Maybe not to the 72% of the United States which is obviously too high considering they don't save enough, but somewhere around two thirds of GDP is the norm. And I think that is actually what they're aiming for.

I think we've covered a lot of ground and we've gone on for very long, and the drinks are waiting for us. So I think we should end here, and thank you very much for all of your questions. And thanks to all the participants and panellists.

[[applause]]