Special Report 2011/14

Living through the Great Uncertainty

This article is the introduction of a series of Special Reports that discuss the downside risks to the global economic outlook, as presented in Rabobank Outlook 2012[1]. For convenience, we provide the conclusions drawn in the reports here. For the complete Special Reports on the identified risks, please refer to our website, www.rabobank.com/outlook2012.

The Great Uncertainty

Not so long ago, the world economy went through a period famously known as *the Great Moderation*. For over two decades, we experienced rising incomes, falling interest rates and falling inflation (volatility). In short, times could not have been better! But then the US subprime crisis made landfall and marked the beginning of a period we would call *the Great Uncertainty*. Since the freezing of wholesale credit markets in the summer of 2007, the world economy has been rolling from one crisis to another. The US subprime crisis did not need to culminate into a full-fledged banking crisis given the relatively small size of the subprime mortgage segment (estimated to be around 3% of US GDP at the time). Yet the sudden loss of confidence owing to the opaque nature of structured finance products backed by subprime mortgages resulted in the freezing up of US wholesale capital markets. Given the deep integration in the global banking sector, the US banking crisis quickly went global. At this point, some analysts believed that a crisis in the financial sector would not affect the world economy. That proved too optimistic as tightening credit conditions and huge corrections in asset prices sent the global economy into a tailspin. To avert a repeat of the Great Depression and a total meltdown of the financial system, policymakers threw everything they had at the crisis. This proved effective as the world economy staged a recovery already in the second half of 2009. Again optimists hoped that we would revert to business-as-usual. Then came the Greek debacle in late 2009. Greece's government shocked and awed everyone by coming clean on its notoriously inaccurate statistics. Once more, some hoped that the Greek crisis would not need result in a crisis in the eurozone given the relatively small size of the Greek economy (it only accounts for 2.5% of eurozone GDP). This rosy prediction proved wrong again. Very soon, countries as large as Italy and Spain were sucked into the crisis as investors starting questioning their fiscal sustainability.

The lesson we can draw from the experiences of the past couple of years is that the world has become a much more unstable and uncertain place. Predicting the future, which was never easy, has become even more difficult. Our base case scenario, as outlined in our Rabobank Outlook 2012, is that the post-crisis recovery will be bumpy, below-par and brittle until the deleveraging process in the Western world comes to an end. While households, firms and governments are busy repairing their damaged balance sheets, the global economy

[1] www.rabobank.com/outlook2012

continues to face major risks that can potentially knock it off course. The six most important known unknowns are discussed in six separate Special Reports. Below, we will give you an overview of all six risks. For extra information please see the Special Reports.

Six downside risks to the global economic outlook

1. Risk of facing a wave of sovereign defaults in the eurozone (or a complete break up) combined with a global banking crisis.

The eurozone is hanging in the balance. Pushing the periphery to carry out a cocktail of reforms and austerity measures may not be sufficient to restore market trust. If so, the european leaders will reach a cross-roads. In our view, once they truly begin to stare into the abyss (i.e. appreciate the potential costs of default/exit), they will do '*whatever it takes*' to resolve this crisis. This can be in the form of a credible signal that euro members are willing to move forward with fiscal and political integration while allowing the ECB/EFSF to ensure market liquidity in the short run to calm market nerves. In our view, this is far less costly than the alternative. However, the intricate task is to get the national electorates on board. Only time will tell whether the politicians will do a convincing job.

2. Risk of sovereign debt crises in the US and Japan

Borrowing costs in Japan and the US remains very low despite adverse shocks to the public finances of the former resulting from the earthquake and tsunami and the credit rating downgrade of the latter following the political impasse during the debt ceiling negotiations. The danger is if these two countries begin to feel 'market-proof'. Without more ambitious fiscal consolidation in the medium-term, a sudden rise in government bond yields, leading to a sovereign debt crisis, remains a distinct possibility. It goes without saying that this will be extremely painful for both countries. According to recent research of Furceri and Zdzienicka (2011)[2], debt crises produce significant and long-lasting output losses, reducing output by about 10% after eight years. What's more, debt crises are found to be more detrimental than banking and currency crises.
Our base case scenario is that both countries will realise that complacency will be eventually punished. It is only a matter of 'when' rather than 'if'. However, should these countries choose not to change course, a major global financial crisis will be in store. Its timing is anyone's guess.

3. Risk of financial repression in the West

The finciancial crises since 2007 have inspired (the proposal of) hords of new financial rules and regulations. Hence the pendulum is beginning to swing away from *laissez-faire* financial markets that we have experienced since the collapse of the Bretton Woods system, toward heavier-handed regulation in response to the global banking crisis of 2008-09. But one cannot help noting that one of the by-products of the design principle of the current regulatory framework is to make it easier to work down the massive public debt overhang. For instance, tighter liquidity standards result in larger bank holdings of government bonds. If such muzzling of the financial sector leads to full-scale financial repression and this is accompanied by slightly higher inflation, then potential growth in the global economy will drop at the worst possible time. We sincerely hope that policymakers will stay clear of such policies. But completely excluding the possibility of financial repression in the future is unwarranted.

4. Risk of hard landing in China

In spite of the increasing headwinds, we see the soft landing scenario as the most likely for 2012, which implies the real GDP growth rate will slow yet remain between 7% and 8% next year. However, the financial sector has weakened as a result of strong credit growth in

[2] The authors use an unbalanced panel of 154 countries from 1970 to 2008.

the past years and is particularly vulnerable in light of the increased headwinds. With external demand slowing as well, a soft landing scenario is becoming more and more dependent on strong growth-supporting policies. At the same time, successfully engineering such a scenario has become more difficult. If the Chinese authorities fail in their efforts, a hard landing scenario, with growth slowing to below 7%, could materialise after all. We can therefore conclude that you can count on China to support global growth next year, as long as you have faith in the expertise of the Chinese captains to navigate through stormy waters.

5. Risk of sudden reversal of capital flows from the emerging markets

A crisis in Emerging Markets (EMs) could negatively impact the global economy, considering the growing importance of EMs in global economic growth. Key to watch are the capital flows towards EMs. A stop or outright reversal of these foreign capital flows, especially short-term hot money, will have adverse effects on local assets as well as economic growth. For next year, it seems likely that foreign capital will flow less lavishly towards EMs. For those few countries still struggling with overheating this might even be good news. The risk of an outright, massive reversal of foreign capital flows is rather limited, although not impossible. A break-up of the eurozone, a hard landing of China, or a balance-of-payment crisis in Argentina could push investors' nerves. This is, however, not our baseline scenario. A comforting factor is that if push comes to shove, many EMs have room to spare to stimulate the economy through monetary or fiscal policy. Unfortunately, this doesn't hold for all EMs, especially the ones hit on multiple fronts – export dependency, retreating bank lines, limited fiscal room. The countries in CEE and some emerging Asian countries therefore seem most likely to face difficult times ahead.

6. Risk of de-globalisation

It is high time for consensus-seeking politics whereas the current political scene is becoming increasingly self-absorbed. We see protectionism rearing its ugly head around the globe. Governments try to look after the short-term interests of the population by trying to block foreign competitors. Both the World Trade Organization and the Global Trade Alerts have warned that the world is becoming increasingly protectionist. After the initial exchange of fire started with the currency wars, nations are increasingly moving towards total economic warfare. It is not too late to head off the storm. Should policy makers in Europe finally be able to work together in order to get the economic house in order, that may send a strong signal to the rest of the world that co-operation by far outweighs navel-gazing.

Concluding remarks

No one can be sure whether any of these risks will pan out in the future. But a *fingers-in-ears-la-la-la* approach may have severely negative repercussions down the road. As any experienced captain will tell you, setting sail without knowing the weather conditions can prove hazardous. So instead of brushing these risks under the carpet and hoping for the best, it is best to form a deep understanding about them. The risks to the global economic outlook will be extensively covered in six separate Special Reports (for more information please visit www.rabobank.com/outlook2012).

December 2011

Shahin Kamalodin (+31(0) 30 - 2131106)
S.A.Kamalodin@rn.rabobank.nl

www.rabobank.com/economics