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Doom 'n gloom

S&P's decision to downgrade US debt has helped trigger a market panic as investors fret about poor policy and lacklustre growth in the United States and the Eurozone.

Monday 8 August was a really bad day for global markets. The S&P500 suffered its biggest daily fall since the dark days of December 2008; commodity prices dropped; emerging market stock markets from Hong Kong to Moscow to Brazil saw big sell-offs; and the ASX200 had about A$32 billion sliced off its value. Then, just to add to the general aura of gloom, as markets descended into a fug of panic, the atmosphere was further choked by flames: London's burning, too.

Moreover, in one of those neat market ironies that, depending on your temperament, either causes you to grin ruefully or to grind your teeth at the madness of it all, while the immediate trigger for the current sell-off was Standard & Poor's (S&P) decision to downgrade the United States' long-term debt rating from AAA to AA+, this has prompted investors to flee to . . . yes, you guessed it, US Treasuries, driving prices up and bond yields down.

So, what on earth is going on?

Well, there's no doubt that in part we are seeing a short-term market reaction to the shock value of the US downgrade and the consequent increase in uncertainty. But it's also the case that markets are being buffeted by more fundamental concerns about the state of the post-crisis world economy, with the absence of growth in much of the developed world and the sovereign debt crisis that continues to rage around the periphery of the Eurozone at the top of the worry list.

Sadly, some of this was all too predictable. In the aftermath of the GFC, a whole bunch of studies of past financial crises and global downturns were published. Most of these had a common message: recoveries from financial crises tend to be slower and weaker than average recoveries; just as recoveries from synchronised global downturns also tend to be softer and shallower than the average; and the typical post-crisis period is one marked by slower growth, higher unemployment and more government debt.[1] So, slow growth, high unemployment, and a public debt problem – all pretty good descriptions of where an awful lot of the post-crisis rich world is right now.

Thus, according to recent revisions to US national accounts statistics, the US economy has, on average, shrunk by about 0.3 per cent in real terms over the

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period 2007-2010. That leaves US output still below its pre-crisis high, and means that the United States has set off on the way to its very own version of Japan's lost decade. Meanwhile, although some Eurozone economies like Germany look to have managed to get back to pre-crisis output levels by the first quarter of this year, the growth performance of the currency area's crisis-hit periphery has been dismal.

Unfortunately, that's not the end of the story. These growth disappointments have been exacerbated by policy mistakes and miscalculations in both the United States and the Eurozone.

In the case of the former, a significant part of the problem has been the hyper-partisan political bickering over the stance of US fiscal policy and a problematic medium-term outlook for public debt in general, and over the decision as to whether or not to raise the US debt ceiling in particular. In the end, the policy circus around the debt ceiling debate managed to deliver arguably the second worst possible outcome, after only technical default. That is, the agreement promised to deliver some token near-term fiscal tightening which is likely to contribute to the weak US growth outlook, while failing to deliver any kind of credible medium-term correction to the US debt trajectory which was allegedly the target of the whole exercise.

The deal also proved insufficient to head off S&P's decision to strip the United States of its prestige AAA rating. In a move that managed to simultaneously trash the credibility of both the downgrader and the downgradee – the US Treasury was able to point out that the ratings agency had made a mistake to the tune of some US$2 trillion in its calculations – the world was treated to the sight of the world's largest economy, the issuer of the closest thing we have to a global reserve currency, and the home of the world's most important financial markets, being told that the quality of its economic policymaking was no longer of AAA standard: a statement of the bleeding obvious you might think, after the debt ceiling debacle. (With ratings agencies already in the doghouse over their egregious mis-rating of complex financial instruments in the run-up to the GFC and in the sights of scapegoat-hunting European policymakers after several painfully-timed downgrades of various European sovereigns, S&P's ratings action looks rather 'brave', at least in the particular sense as used by Australian and British officialdom.[2])

If recent developments have been depressing in the United States (and they have), they have been even more dire in the Eurozone. Eurozone policymakers have so far proved completely unable to stem the rolling debt

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crisis that began with Greece and that has since spread to engulf Ireland and Portugal. When yields on Spanish and, even more worryingly, Italian debt spiked upward, it began to look like the euro's last stand. While Greece, Portugal and Ireland are relatively small elements of the Eurozone economy, Spain and Italy together account for close to 30% of the region's GDP. The size of their economies and the scale of their debts means that they are both 'too big to fail and too big to bail.' The European Financial Stability Facility (EFSF) has so far proven inadequate to deal with even the smaller Eurozone economies, and even the beefed up version currently planned by Brussels would not command the kind of resources needed should these two economies require a full-scale rescue.

In fact, there is probably a reasonable case to be made that – unlike some of their smaller counterparts – neither country is facing a fundamental solvency problem. Nevertheless, over the past couple of weeks an unpleasantly familiar story had begun to unfold. Markets, spooked by fears about a possible future inability to pay, began to bid up the risk premium on these countries' debts, which in turn drove up their borrowing costs to the extent that their initial fears were in danger of becoming a self-fulfilling prophecy. What's worse, the typical policy prescription under these circumstances – to impose fiscal austerity – runs the risk of exacerbating the situation. That's because the resultant blow to economic activity can drive down government receipts while pushing up (some) elements of government spending, further undermining the fiscal position, even as the consequent downturn damages the political position of the government and so drives up political risk. All of which then provides ample cause for another increase in risk premia and a further step on the downward spiral to a debt crisis.

For now, the European Central Bank (ECB) has managed to postpone this spiral via the deployment of another acronym – the SMP or Securities Markets Programme – to directly buy up Spanish and Italian debt. So far, that has been sufficient to reverse a good part of the rise in bond yields, and hence buy the Eurozone some more time. But nobody thinks that this is a permanent solution. Instead, it is increasingly clear that such a solution will have to involve a radical restructuring of the whole Eurozone project – perhaps through a significant shift towards some kind of fiscal union (say via a *very* significantly expanded EFSF) to accompany the existing monetary union or alternatively in the form of a two-tier euro. While a restructuring in some shape or form is beginning to look unavoidable, however, it is still an open question as to whether that restructuring is led by Brussels, or whether the endgame is a much messier one.

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So, with the two most important economic components of the developed world having such a torrid time, it's hardly a surprise that the outlook for the world economy has worsened, and that markets have taken fright.

Back at the height of the GFC, the world's policymakers came together at the G-20 leaders meeting in London in April 2009 under a great deal of pressure to ensure that the meeting did a good job of reassuring markets (and the rest of us) that the world's leaders knew what they were doing. In the event, the London Summit did make a reasonably good job of helping stabilise a very volatile global economy. Unless there is a radical swing in market sentiment back towards optimism in the next month or so, the November 2011 G-20 meeting in Cannes is shaping up to be a similar make-or-break affair. Assuming, that is, that the world economy can wait that long.

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[1] See for example the discussion in IEC#2, *'New Normal' or just the same old nasty?*
[2] 'That's a very brave decision' = 'That's a completely insane decision'.

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