



The world economy, Murphy's law and Finagle's corollary

While a more proactive ECB has been able to halt the slide to Eurogeddon, the world economy remains highly vulnerable to adverse shocks.

Murphy's Law: whatever can go wrong, will.
Finagle's corollary: whatever can go wrong, will, at the worst possible time.

It's getting harder to remember, but the early part of the current century delivered a fairly pleasant period of high growth and low volatility for the world economy. Unfortunately, this came in part at the cost of storing up some unpleasant problems for the future. Much of the developed world had been riding the upswing of a debt supercycle that came to an abrupt and devastating halt with the fall of Lehman Brothers.

The paradigm that has succeeded this period of debt-driven growth is proving much less congenial. It has seemed at times to have involved the prolonged and vicious application of Murphy's Law: whatever could go wrong with the world economy, has. Over the course of 2008 alone, policymakers found themselves juggling:

- a global food crisis, when in the year to July 2008 the Food and Agricultural Organization (FAO)'s food price index rose by more than 50%;
- surging oil prices, which approached US\$150/barrel;
- a major international financial crisis which threatened to tip the world into another Great Depression, and which even after an unprecedented degree of fiscal and monetary policy intervention nevertheless still managed to deliver a synchronised global downturn along with a Great Recession across much of the developed world.

An important repercussion of the last and largest of those adverse shocks has been an increase in the overall fragility of the world economy due to a widespread deterioration in the economic health of the developed world. Three factors have been at work here:

- The legacy of pre-crisis excesses – in particular, the parlous state of household and financial sector balance sheets in many developed economies – which has required and continues to require a prolonged period of painful deleveraging.
- The consequences of the policies deployed in order to deal with the crisis, primarily the offsetting expansion of public sector (government and central bank) balance sheets, which has eroded the policy space



available for dealing with any subsequent crises and produced a sharp rise in public sector indebtedness.

- The severe financial aftershocks that have followed the initial onset of the crisis in 2008.

All three factors have acted to reinforce each other: financial sector and household deleveraging has depressed growth, with adverse consequences for sovereign debt sustainability, while continued crises have spooked markets, investors and consumers, further undermining growth prospects and jacking up risk premia.

An early warning of the consequences for a fragile post-crisis economy came in November 2009 with the Dubai debt crisis. More serious consequences arrived in December 2009 when the recently elected Greek government announced that its predecessors had been cooking the books, and that Greece's true debt position was in fact much worse than had been previously reported. Ratings downgrades duly followed and as the world economy moved into 2010 the problems began to spread around the Eurozone periphery, taking in Ireland, Portugal and Spain. By May 2010, the Eurozone and the IMF were announcing a 110 billion euro rescue package for Greece, and by November that year an 85 billion euro package for Ireland had followed. Portugal received its own bailout in May 2011.

Meanwhile, other significant adverse shocks to hit the world economy over this period included the unrest in Tunisia in late 2010 that sparked the Arab Spring and the tragedy of the Tohoku earthquake and tsunami in Japan, which also represented a major blow to global supply chains.

Despite all of this bad news, by mid-2011 there were some hopes that the worst might be over and that the world economy could start to build a sustained recovery. Unfortunately, Murphy's law continued to apply and the second half of 2011 saw risks increase again. Initially, the focus was on the United States, where hyper-partisan political bickering produced first the policy debacle that was the debt ceiling debate and second (and consequently) the decision by Standard & Poor's to strip the US of its coveted AAA sovereign rating.¹ But the main problem was in the Eurozone, where a series of brutal adverse feedback loops had kicked in.²

The source of the problem was the close ties between sovereign risk and the Eurozone's banking system resulting from the latter's sizable holdings of Eurozone government debt. These large exposures meant that as fears



about debt sustainability in the Eurozone periphery mounted, so too did concerns about asset quality on Eurozone bank balance sheets. This in turn created strains on the liability side, as the perceived riskiness of Eurozone banks drove up funding costs in response to rising counterparty risks. Since many Eurozone banks were both heavily reliant on wholesale funding and facing substantial short-term financing requirements, exposure to rollover risk was substantial. This was further exacerbated by the fact that a large chunk of this short-term funding was in the form of dollar borrowing from US money market funds and increasingly subject to the risk of rapid withdrawal.

Banking sector problems produced a credit squeeze which further undermined growth prospects, which then worsened the sovereign debt situation (and undermined political stability) which increased the questions over bank asset quality and so on. And of course, since all of this was taking place within a single currency area with a dense network of financial and trade linkages across countries, the scope for contagion was extremely high. As a result, by the final quarter of 2011 Eurozone banks were facing severe funding problems with the prospect of large scale refinancing requirements over the first quarter of 2012. Eurogeddon appeared to be looming.

This deteriorating economic environment meant that by the start of 2012 both the IMF and the World Bank used their January forecast updates to warn that downside risks to the world economy had risen, with the Bank in particular emphasising that what in 2011 had been cast as a possible adverse scenario for the global outlook had now morphed into its central case.

In fact, by the start of this year the immediate risks of Eurogeddon had already receded somewhat. In large part, this was due to a change in approach by the European Central Bank (ECB) under the recently appointed Mario Draghi. Towards the end of 2011, the ECB introduced a new three-year Long-term Refinancing Operation (LTRO) – a long-term collateralised loan at a very low interest rate, where the acceptable collateral included Eurozone sovereign debt – and proceeded to make almost half a trillion euros worth of loans to Eurozone banks, a sum equivalent to roughly five per cent of Eurozone GDP. This new approach had two positive effects. First, it eased the liquidity crunch facing many Eurozone banks by providing them with access to a source of cheap long-term financing, removing fears of an imminent funding crisis. Second, it produced positive spillover effects on Eurozone sovereign borrowing costs, by encouraging the banks to buy government debt and use it as collateral at the ECB.



While the ECB's actions have staved off an immediate financial crisis, however, the global economy is far from home and hosed. For a start, although the ECB has bought policymakers some time and alleviated the worse of the credit crunch, this has done nothing to deal with the underlying competitiveness problem that bedevils much of the Eurozone periphery or to resolve Greece's solvency issue.³

More generally, the world economy remains fragile and vulnerable to further setbacks. There is a troubling list of potential shocks to pick from, including:

- the likelihood of more Eurozone problems, ranging from the possibility of a Greek default and/or Eurozone exit on to the more extreme scenario of a wider breakup;
- the spread of sovereign debt fears beyond the Eurozone to encompass other sovereigns with stretched balance sheets and problematic medium-term debt trajectories, primarily the United States and Japan;
- the possibility of geo-political shocks with Iran (and the oil market) currently top of that particular worry list.

Moreover, should one or more of these risks materialise, there is strictly limited fiscal and monetary policy space available in most of the developed world to manage the fallout. To a lesser extent, this is also true of the developing world, where the aggressive response to the 2008-09 crisis has left several countries with appreciably less fiscal space than before.

With all these risks in mind, the thought that the world economy has been living through a period of Murphy's Law is a depressing one. More depressing still is the prospect offered by Finagle's corollary to Murphy's law: not only will anything that can go wrong, go wrong, but it will tend to do so at the worst possible time. Best to cross our fingers and hope that the world economy is now set for an overdue period of good luck and no crises, then.

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¹ See IEC #21.

² The importance of these adverse feedback loops has been a consistent theme in recent issues of the IMF's Global Financial Stability Report, from October 2010 onwards.

³ They have also increased the banking sector's exposure to Eurozone sovereign risk.