World Economic Prospects in the Context of an Ongoing Global Crisis

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WORLD ECONOMIC PROSPECTS IN THE CONTEXT OF AN ONGOING GLOBAL CRISIS

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Abstract. *The current financial crisis which started in 2007 and is still ongoing in 2010, was triggered by a liquidity shortfall in the United States banking system and has been considered the worst financial crisis since the Great Depression of the 1930s, since it affected drastically most countries in the world, big corporations and contributed to declines in consumer wealth and a noteworthy downward spiral in the economic activity.*

In these times of global depression, most countries and companies are affected, some more than others. The financial crisis is turning out to be much deeper and broader than expected. This paper underlines what is the outcome of the financial crisis on the global economy and synthesises the main opportunities for companies in these unstable years.

Keywords: *crisis, unemployment, happiness index, oil demand.*

1. Introduction

The collapse of a global housing bubble caused the values of securities tied to real estate pricing to drop thereafter, having a negative impact over the financial institutions worldwide. The financial crisis had its starting point in the U.S. housing market and was restrained to slowing growth prospects in the U.S., Canada and Europe for almost two years (2007 and 2008). At the crisis' early stages, economists considered that developing economies would be invulnerable (the so-called "decoupling hypothesis"). Now we can conclude that this theory was at least naïve. In the era of globalization, the emerging markets, especially China, Brazil or India cannot be kept away from the downturn of the global economy.

The advanced economies severe decline caused demand for emerging economies exports to drop and the crisis became truly global, much deeper and broader than expected. The black series of bankruptcies has shattered the trust of people in the key financial institutions, in the rating agencies,

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even in the markets ability to normalize their own irregularities. The case of Lehman Brothers, once the fourth-largest US investment bank, scared the world-it filed for bankruptcy protection on September 15, 2008. The bankruptcy of Lehman Brothers was the largest bankruptcy filing in U.S. history with Lehman holding over $600 billion in assets.

Credit rating agencies failed to accurately evaluate the risk involved with mortgage-related financial products and governments did not adjust their regulatory practices to address contemporary financial markets

However, it should not be any surprise, since even the free-market symbol, Adam Smith warned that markets and the invisible hand did not always produce socially-desirable effects and that there was a responsibility for governments in monitoring and channeling the mechanisms of markets.

Even the Marxian theory, although considered obsolete by many critics, warned that a “conjuncture” in a “chaotic” capitalist development, will if no countervailing action is taken, mark the transition to a recession or depression.

The truth is that many causes have led to the global economic melt-down: the easy credit conditions, the escalation of the housing bubble, the sub-prime lending, the complexity of the markets and financial instruments or, why not, the failure of top world economists and leaders to anticipate or to take steps in order to avoid a systemic crisis.

After September 2008, the advanced economies severe decline caused demand for emerging economies’ exports to drop and the crisis became truly global, much deeper and broader than expected.

In this era of global depression, most countries and companies are affected, some more than others. The financial crisis has turned out to be much deeper and broader than expected. Managers, researchers, politicians keep asking themselves: how deep will the recession be and how long will it last?

2. Effects of the financial crisis

Many people praised, at the beginning of the new millennium, the benefits of the globalization phenomenon: growth of the living standards express thanks to the specialization, pursuit of comparative advantage, intense trade between countries or advance of the technology. Yet, even before this crisis, globalization was already being challenged-critics argued that globalization favoured capital rather than labour and the wealthy rather than the poor. The crisis has accentuated the differences between have and have-nots. For example, tiny Iceland is emerging as the biggest casualty of the global financial crisis[1]. Relative to the size of its economy and population (only 304.000 people), Iceland's banking collapse, which involved all the three major banks is the largest suffered by any country in history.

Right away after the shocking avalanche of bankruptcies from September 2008, the world governments started to inject capitals in their economies, while banks cut their interest rates in order to help borrowers and remain profitable. The U.S. alone executed two stimulus packages, totaling nearly $1 trillion during 2008 and 2009. Many people have criticised these measures, considering them as a waste of money, while others have applauded the intervention of the states in the economy.

On the occasion of the speech held by Barack Obama, the American President, in favour of the $787bn economic stimulus plan of 2009, he said "we have a once-in-a-generation chance to act boldly and turn adversity into opportunity and to use this crisis as a chance to transform our economy for the twenty-first century"[2].

Rumours concerning bank solvency, turn down in credit availability and lack of investor confidence had a severe impact on global stock markets, where securities suffered huge losses during late 2008 and early 2009.

The rich industrialized countries entered in 2008 a recessionary period; export-dependent nations such as Japan, Germany, South Korea and China are suffering from the contraction in global demand and have turned to their domestic markets. Even the Arab world, once a flourishing group of states, reported losses in 2009, as a result of failed investments in foreign markets and the drop in oil prices.

Some developing countries that had seen strong economic growth saw significant slowdowns. The emerging countries, which grew on average 7 to 8% during the past few years, slow to an average of 3% in 2009. The most vulnerable remain the countries that depend on foreign capital (such as Hungary, the Baltic states, Turkey, Central Asia) and those that have big current account deficits.

No wonder that the foreign investments flows to the developing countries have sharply declined during the years of crisis, as shown in figure 1. Overall, net private capital flows to developing countries in 2009

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[1] Capell Kerry, *The Stunning Collapse of Iceland,* Businessweek, October 9, 2008.
[2] BBC News, *US Congress passes stimulus plan,* 14 February 2009.

are estimated to have fallen by $795 billion (relative to their high in 2007), or by almost 70 percent. Even with recovery on the horizon, projected flows in 2010 are only $517 billion, or 3.2 percent of GDP.

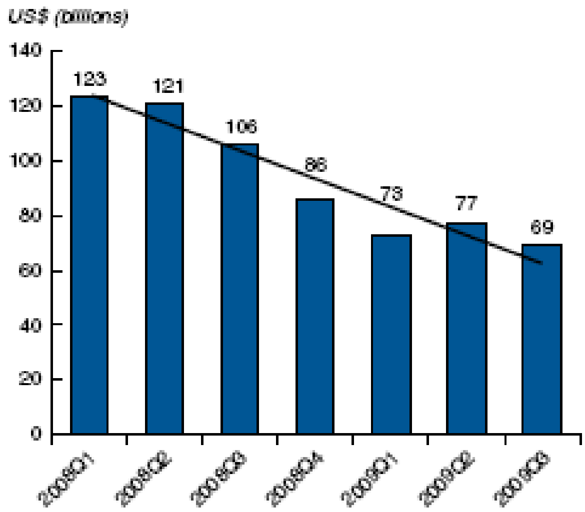

Figure 1. FDI flows to developing countries.

Source: International Bank for Reconstruction and Development / The World Bank Global Economic Prospects/Crisis, Finance, and Growth-2010, p. 38.

A good example of what the financial crisis has meant for a developing country is **Romania**, whose rating has been downgraded by Standard & Poor's agency in the fall of 2008 to junk level, meaning a dangerous exposure of the banking system, because of a high rhythm of loan agreements, a system unable to face a profound crisis of liquidities at global scale.

On March 24, 2009, Romania has reached an agreement for a total funding of 19.95 billion Euros, of which 12.95 billion Euro from IMF, 5 billion Euro from the European Commission, EUR 1 billion Euro from World Bank and a one billion Euros from the European Bank for Reconstruction and Development (EBRD). The main conditions for receiving installments under that agreement are related mainly to reduce public spending is badly needed: wages decrease, reforming the public pension system, adoption of fiscal accountability law, which creates a framework of state budget on a medium term of 3-4 years. Fortunately, in this situation that seems dramatic to Romania, one of ray of hope regarding financing comes from the structural funds, financial instruments created by European Union, in order to assist member states post-accession modernizing process. These funds, in a total amount of 32 billion Euro, can be accessed until 2013. Structural funds are therefore a possible answer to the Romanian economic crisis. Of the total Structural Funds is 5.77 billion Euro direct contribution to competitive programs and 15.8 billion Euros, an indirect contribution to regional development programs, human resources, environment and transport.

3. Unemployment – the most disagreeable outcome of the economic crisis

An indicator that painfully shows of how much the crisis really hurts is the unemployment rate. It has increased significantly over the past 18 months, across all sectors. Unemployment among OECD member countries alone has increased by 25.5 million since the start of the crisis and some estimates suggest that globally the increase could total over 50 million in 2010. Jobs are not created as fast as they are lost and any prolonged period of high unemployment will have undesirable effect on consumption.

Very few countries succeeded to maintain a decent level of unemployment rate. In Germany, for instance, unemployment has so far increased only marginally (by 0.3%, from 7.2% in October 2007 to 7.5 in October 2009), compared to an increase of 4.4 percentage points over the same time period in the US (from 5.8% to 10.2 %) or over 8 percentage points in Spain (from 11.4% to 19.3%). Germany has also taken steps to shorten working hours, rather than cutting jobs and to maintain people in employment, if only part-time.

One aspect, common to both the developed and developing world, is that unemployment has an excessively large impact on youth and the effects of poor job opportunities early on in the working life have, usually, negative effects for earning power and development over the rest of an individual's career and life. Moreover, people are forced now to accept part-time jobs or under their level of skills.

To worsen things, according to the International Labour Organization only 20% of the world has adequate social protection, 50% of the world has any coverage at all, while in developing countries that figure falls to less than 10% of their population.

In a recently disclosed report[3], the International Labour Office presents the case study of Brazil, a very suggestive one, because is

[3] International Labour Office, *Global Employment Trends,* January 2010, page 32.

conclusive for many emergent countries, which have roughly followed a similar scenario in the past 12 months.

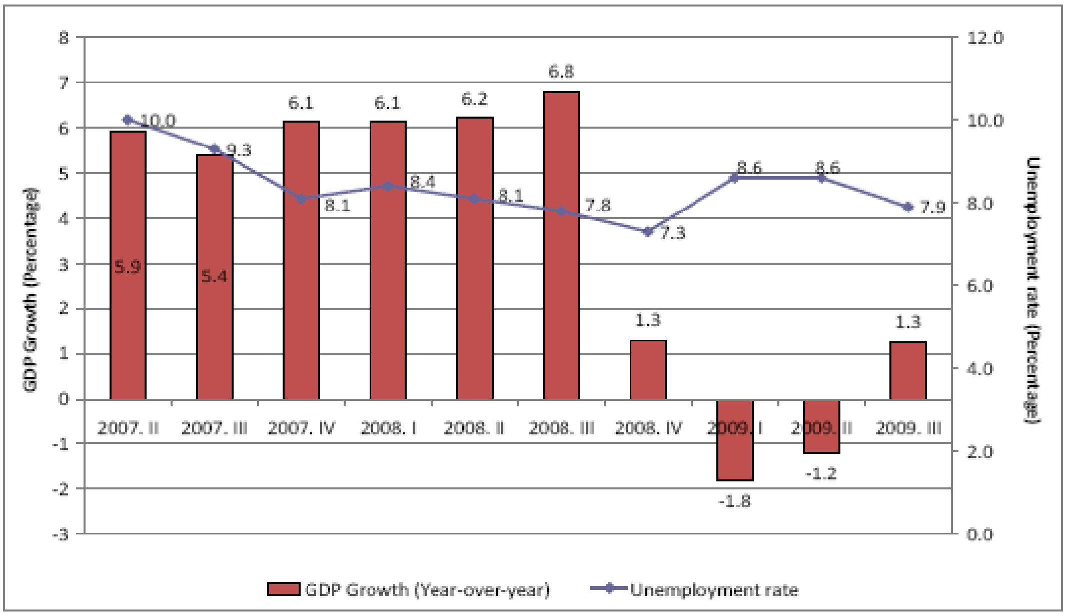

Figure 2. Brazil: GDP growth rate and unemployment rate, by quarter (percentage).

Source: Central Bank; IBGE.

Before the start of the economic crisis in Brazil in September 2008, the economic growth had been steady, with 4 years of robust growth, with a peak in the third quarter of 2008 as figure 2 depicts. Furthermore, there was a significant recovery of wage levels and an increase in employment, particularly formal employment. Yet, the international crisis halted economic growth and had an instant and sharp impact on employment. The GDP growth in the fourth quarter of 2008 decreased to 1.3 per cent and there was a net job loss of 634,000 formal jobs in the quarter, compared with a net gain of 10,400 formal jobs in the fourth quarter of 2007.

Only in the third quarter of 2009, economic growth had resumed and the unemployment rate had returned to near pre-crisis levels (in October 2009 the unemployment rate of 7.5 per cent was equivalent to the rate for October 2008).

Some researchers succeeded to obtain a transatlantic comparison of the so-called ‘happiness index’, which combine consumption and unemployment. From this standpoint, during the crisis, Europe does only to some extent better than the US. The difference is small because unemployment is usually much more stable in Europe. However, strong differences exist within the euro area, with a clear hierarchy: Germany is better off than all the others, with little deterioration in its index while Spain is at the other extreme. If we look at figure 3, we can clearly notice that 2009 is by far one of the darkest years of the last decades, a year of despair, characterized by high unemployment rates, plunge of consumption and lack of hope.

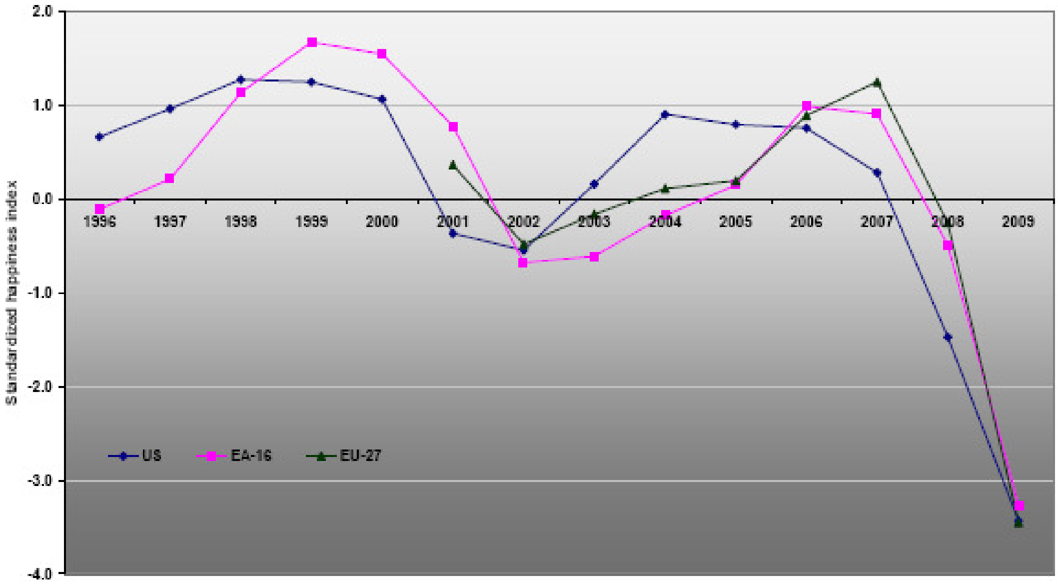

Figure 3. Standardised 'happiness index': the US and Europe.

Source: Daniel Gros and Cinzia Alcidi The Impact of the Crisis on the Real Economy, page 5, Centre for European Policy Studies, CEPS Policy Brief, nr. 201/2010.

4. The upside and downside of the economic crisis over the environment

Definitely, current economic crisis determine companies to produce and trade less, people to drive or fly less, consume less energy, hence lowering expectations for greenhouse-gas emissions, which is the bright side of the crisis.

Unfortunately, less consumption undeniably leads to a serious decrease of worldwide production, but also to a decrease of using raw materials. As oil consumption declines, the price of oil is also dropping, thus discouraging investment in expensive "green" projects. It will not worth to poor money into expensive eco-friendly technologies, since alternative energy costs will be much higher than those related to classical sources of energy. If the prices for oil and gas keep falling, the incentive for utilities and consumers to buy expensive renewable energy will shrink. That is what happened in the 1980s when a decade of advances for alternative energy collapsed amid falling prices for conventional fuels.

The world oil demand has dropped significantly in the second half of the year 2008 and in the first half of the year 2009 (see Fig. 4). The price of oil has plunged dramatically, from $147.50 in July 2008 to $40 a barrel in January 2009.

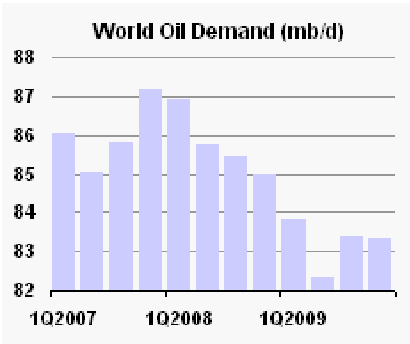

Figure 4. Oil Market Report-Highlights of the latest OMR, dated 14 May 2009.

Source: International Energy Agency.

As the International Energy Agency makes public in its Oil Market Report-Highlights of the latest OMR, dated 15 January 2010[4], the forecast global oil demand remains virtually unchanged –86.3 mb/d in 2010 (+1.7% or +1.4 mb/d versus the previous year). Growth is driven by non-OECD countries, most notably in Asia. In the last months of 2009, the world oil demand rose, but still remained under the levels of 2008 (see Fig. 5).

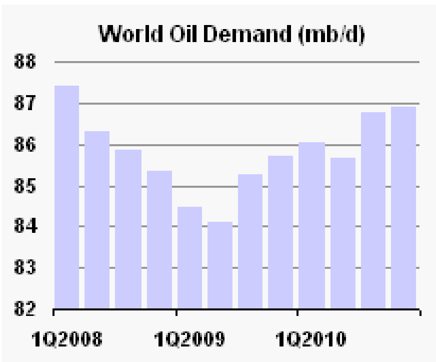

Figure 5. Oil Market Report-Highlights of the latest OMR, dated 15 January 2010.

Source: International Energy Agency.

[4] http://omrpublic.iea.or.

The economic crisis has scared the politicians. Leaders of some European Union countries are calling for a slowdown in efforts to curb emissions of greenhouse gases due to the growing economic crisis. Under huge pressure to shield German industry from the cost of going green, however, Angela Merkel, the German Chancellor, fights to reverse key goals that she once championed. Under a plan adopted by the EU in 2007, member countries pledged to reduce such emissions by 20% below 1990 levels by 2020, which is far more ambitious than the Kyoto Protocol. Merkel was then the "Iron Lady" who pushed through tough climate change targets to show that Europe could lead the world in beating global warming. However, in December 2008, she demanded free carbon credits for 90 to 100 per cent of German factories until 2020 – blowing a hole in a key climate change scheme[5]. Prime Minister Silvio Berlusconi of Italy and the leaders of some Eastern European countries, like Poland, pointed out as well that due to the crisis, they were no longer able to finance the high costs of attaining the 2020 goal and so weren't prepared to adopt a detailed plan.

5. Temperate confidence for the future years

A recent study[6] conducted for Deloitte Touche Tohmatsu by Forbes Insights reveals that economic optimism reached its highest level in the past 12 months among surveyed executives only in December 2009. The analysis discloses that in the last month of the year 2009, more than one-third of the executives surveyed (35%) believe the worst of the economic crisis is behind us-the highest level of economic confidence since the survey began in January 2009 (Fig. 6). The data comes from a survey of 335 senior executives and talent managers from large companies (annual sales $500+ million), across a range of many industries and the three major economic regions, the Americas, Asia Pacific (APAC), and Europe, the Middle East, and Africa (EMEA).

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[5] The Times-December 11, 2008, Angela Merkel turns her back on green dream of EU.

[6] Deloitte Development LLC – Managing talent in a turbulent economy, January 2010.

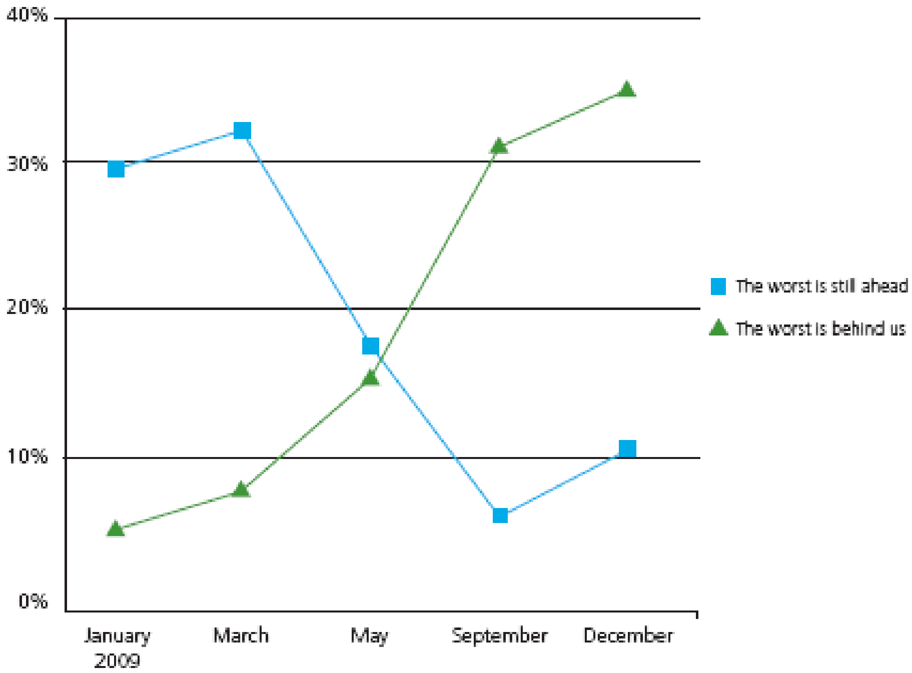

Figure 6. Executive outlook on the economy (December 2009).

Source: Deloitte Development LLC.

Indeed, the forecast of IMF suggests the same positive trend will follow the major economic indexes. The world trade volume is expected to rise in 2010 at 5.8 per cent (Table 1) compared with a dramatic –12.3 per cent in 2009. The oil prices is predicted to get much higher in 2010 (22.6 per cent in 2010 compared to a sharp drop of –36.1 in 2009). Projections are good for 2011 as well.

Without doubt, the progress of the last months of 2009 gives hope to worldwide entrepreneurs, since the pace of economic contraction is slowing and the financial markets are recovering from decline. However, household spending remains constrained by job losses, lower housing wealth and tight credit. Most reports suggest that unemployment will fall faster in the US than in Europe. The difference is attributable to the flexibility in US labour markets but, even with this, the US will be affected by widespread plant closures and continuing bankruptcies among small and medium size enterprises.

Coming out of the crisis, the world has a historical chance to reshape its policies, architecture and institutions and support balanced global growth and financial stability. People seem to fail to remember about the probability of crisis outbreak in times of prosperity and fail to take quick crisis management actions. Especially the emerging economies should avoid macroeconomic imbalances and to follow a sustainable growth trend backed by structural reforms. The current financial crisis has highlighted the need for up-to-date and transparent information by type of instrument, currency, creditors, and debtors.

Table 1

Overview of the World Economic Outlook Projections

Indicators	Projections (%)			
	2008	2009	2010	2011
World trade volume (goods and services)	2.8	–12.3	5.8	6.3
Imports				
Advanced economies	0.5	–12.2	5.5	5.5
Emerging and developing economies	8.9	–13.5	6.5	7.7
Exports				
Advanced economies	1.8	–12.1	5.9	5.6
Emerging and developing economies	4.4	–11.7	5.4	7.8
Commodity prices (U.S. dollars)				
Oil	36.4	–36.1	22.6	7.9
Nonfuel (average based on world				
commodity export weights)	7.5	–18.9	5.8	1.6
Consumer prices				
Advanced economies	3.4	0.1	1.3	1.5
Emerging and developing economies	9.2	5.2	6.2	4.6

Source: International Monetary Fund[7].

Many companies are rethinking the way they address social issues, especially in emerging markets. An online survey of McKinsey[8], May 21, 2009 – June 3, 2009, received responses from 2,245 senior executives from around the world. The results demonstrate that for managers the most important drivers of economic growth in developing and emerging economies over the next 10 years are:

1. education (21%)
2. trade and economic integration (18%)
3. private-sector development (16%).

[7] http://www.imf.org/external/pubs/ft/weo/2009/update/01/pdf/table1.pdf.

[8] https://www.mckinseyquarterly.com/Strategy/Strategy_in_Practice/Rethinking_how_companies_address_social_issues_McKinsey_Global_Survey_results_2514.

But the crises do not bring out only losers; there are opportunities for savvy companies able to involve the entire staff in supporting new market entry strategies, guidelines for increased efficiency, by minimizing risks and cutting costs in key areas.

The attempt to enter new markets has always been a risky entrepreneurial act, but also a rewarding one, in the case of success. Producing profits from selling or producing abroad are great achievements for firms trying to expand their market share in foreign countries.

Well-capitalized companies, with robust financial positions and with liquidities to invest, have now a unique chance to make strategic acquisitions and to buy previously unaffordable assets. Of course, it takes audacity to act in a risky climate, but as more and more targets become available, taking advantage of this occasion will help daring companies to have success in the years of boost after the crisis.

In a survey realised by us between September15-December 31, 2009, we scrutinized the greatest risks taken into account by 40 managers, economists and analysts, which could have affected the prospective for development of the companies they were working for. The results showed that most of them feared a shrinking in the market share (40%), followed by default or incapacity to pay debts (32%) and other risks with lesser significance: asset price collapse (15%), oil and gas prices volatility (6%) and pandemic risk (7%) (see Fig. 7).

Many analysts come out with new ideas and models for the so called "new economy" and the "new financial order". For instance, a new world order for a stable society[9] would entail, among others, that the current practice of crediting both the production and the consumption, in other words facilitating at the same time the initiative of both "making and taking", and financing companies and individuals at the same or comparable amount should fade away. A producer could develop its business 100% on credit whereas an end user may do the same thing, but the burden is actually over the people who had the power to spare and hence had financed the banking system. This model, where consumers unable to spare even a cent hope and even succeed to finance a living standard far beyond their possibilities and where the social-economic development is based exclusively on other people's money, well, this model should disappear.

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[9] Mihail Brînzea, *The New Financial Order and Redefining Power According the Saving Capacity. The Crisis Opens new Respects to New Models*, http://mihailbrinzea.finantare.ro, 9 February 2009.

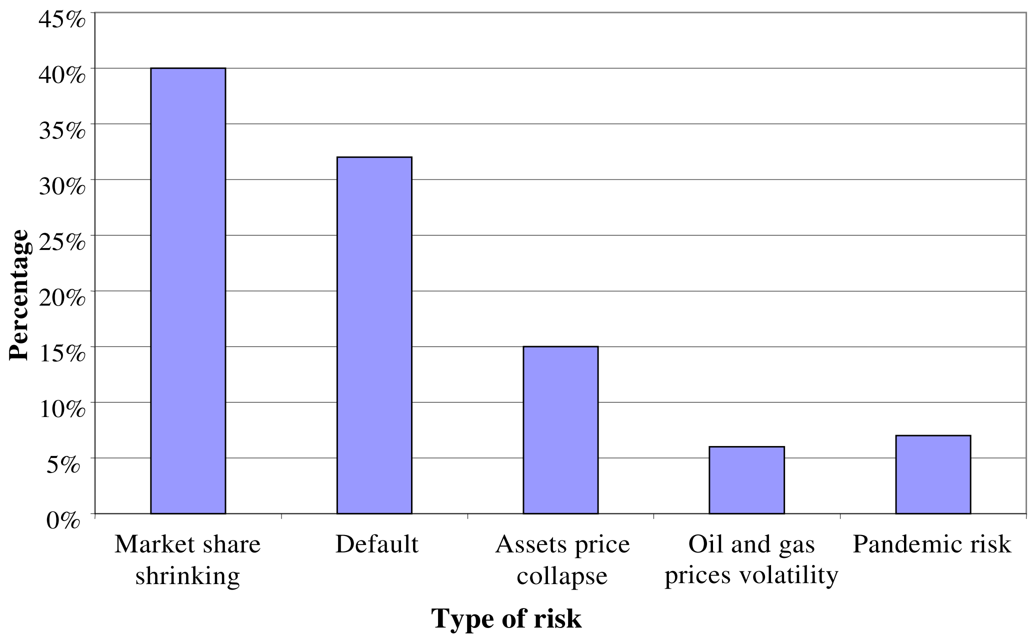

Figure 7. Managers viewpoint on the highest risks most likely to affect their companies (December 2009 survey).

Source: Anda Gheorghiu, a survey realised between September 15-December 31, 2009[10].

6. Conclusions

How will this crisis be remembered in the history books? As a systemic crisis and a turning point in the economic paradigm of capitalism, or as a transitory, soon reabsorbed accident?

In a nutshell, the crisis has burst due to a number of specific technical problems in the functioning and regulation of financial markets and it has been exacerbated by a number of mistakes made during the management of the crisis.

The abolition of Glass-Steagall Act by the US in 1999 had the consequence of inducing the banks to play the markets for quick profit. The repeal of the Glass-Steagall Act of 1933 in fact removed the separation that up to that time existed between Wall Street investment banks and depository banks and has been blamed by some for exacerbating the damage caused by the collapse of the subprime mortgage market.

[10] Anda Gheorghiu, a Poll realised on http://polls.linkedin.com/p/56818/gokpq (What is the greatest risk for your company in 2010?), 40 answers.

Other roots of the deep economic downturn that are truly significant are: the bonus-driven culture, the regulatory failure in the financial sector, the promotion of a false belief that banks or financial institutions are too big to fail and the oligopolistic nature of rating agencies (only three agencies dominated the market in the past decade – Standard&Poor, Moody's, Fitch).

If companies and states will be able to learn from these mistakes and manage the recovery from the crisis well, the economy will be back to a better shape, with less excesses and more stability.

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[10] The Times-December 11, 2008, Angela Merkel turns her back on green dream of EU.