

After the crisis, what next?

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IESE Prof. Antonio Argandoña describes what precipitated the crisis and presents the outlook for the world economy.

To fully comprehend an economic cycle, one must understand the factors that defined its predecessor. The excesses of thriving economic times are what inevitably bring about recession.

This maxim rang true once again, starting in 2007. A long period of macroeconomic stability, high growth and low interest rates inflated the housing bubble and helped induce the financial mistakes that led to the crisis.

In his article, "[El panorama macroeconómico de la economía occidental y la crisis financiera](#)" ("The Macroeconomic Side of the Western Economy and the Financial Crisis"), [IESE Prof. Antonio Argandoña](#) analyzes the state of the world economy at the start of the 21st century and offers an interpretation of the post-crisis panorama to evaluate whether it is possible to see a return to the conditions that fostered that previous economy.

Long period of prosperity

The years following the oil crises of the 1970s and the adjustments of the early '80s were about "great moderation." For more than two decades, the expansion periods were long, recessions were mild and inflation rates were low.

The extended bonanza was due to the lack of serious disruptions and the continued low interest rates resulting from both the surplus of savings worldwide and the expansive monetary policy of the United States.

The consequence was a period of booming growth and abundant liquidity, which generally leads to rising inflation.

This did not happen because there was a moderation of labor costs. However, all the ingredients were in place for bubbles to be formed. And at the end of the '90s, one of them burst: the dot-com bubble.

Inflating the bubble

The U.S. Federal Reserve found a solution to the recession caused by the collapse of the dot-com companies: it lowered interest rates to 4.75 percent. That fueled family debts, consumption and the housing demand.

When the situation returned to normal, the Fed maintained its policy of low rates, which created a sense of euphoria that in turn led to a worldwide bubble in the real-estate market.

This anomalous policy was followed by others, including the central banks of Europe and Japan. The result: more spending, less saving.

The cheap money produced an unexpected effect: the demand for earning assets went to markets for materials and foodstuff, in search of profitability that was not being generated elsewhere.

Financial innovations were another factor that, along with the abundant liquidity and low interest rates, helped inflate the bubble. Among those new products, Argandoña calls attention to the rise in subprime mortgages, securitization and the development of the shadow banking system.

This all led to a worldwide crisis and recession.

What lies ahead

To address the difficult situation at hand, governments have responded in the first part of 2009 with measures focusing on two objectives: containing the recession and pushing toward recovery. So, what's the outlook for the next few years?

A number of factors will help determine the macroeconomic framework in the near future.

- In the short term, it appears that interest rates will remain low, given the formidable creation of global liquidity by the central banks.

- Spending and public deficit will both increase. Many governments are sacrificing fiscal discipline in an attempt to achieve immediate recovery of aggregate demand. However, these measures will entail medium-term costs, such as costlier credit. Therefore, we expect higher rates in the medium term - which could be quite soon.
- We are unlikely to see a repeat of the growth rates experienced in recent years. In terms of consumption, moderation will be the trend. Families will have to reduce their debts and there will be a greater tendency toward saving. Presumably, the demand for consumer credit will diminish and the real-estate market will be lethargic. Investment will also be more restrained.
- The real-estate, construction and financial sectors, among others, should return to more sustainable levels. The conditions and structure existing in each country, their ability to generate enterprising initiatives and their flexibility in allocating resources will determine which sectors pick up first.
- In the long term, the potential growth rate will be more restrained than when housing was driving the economy, for reasons including increased regulation for the financial sector, a volume of credit that will not grow as it did before, as well as higher interest rates and risk premiums.
- Worldwide imbalances, particularly the disparity between the savings and spending of certain countries, will be reduced, albeit mildly.
- The price of oil will be restored when demand is restored, at which point the supply shortage will be exacerbated. As such, the upward trend of the price per barrel is likely to become accentuated in the future.
- Europe will remain sluggish and the United States will continue to lose clout in the world economy. However, Japan will not likely step into the breach. For that, all signs point to emerging countries, particularly India and China.
- The recession will likely encourage protectionism, interventionism and economic nationalism, which can only prove harmful to the prospects for worldwide growth.

We do not know whether we will suffer another crisis of this magnitude, or what direction will be taken with the new approaches to economic theory still being made up as we go along.

Nonetheless, as Argandoña states, the focus should not be on looking for someone to blame, but rather on introducing the necessary reforms so that a similar crisis does not strike again.

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