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Downturn: How Hard, How Long?



The troubles may have started over a year ago in the U.S. housing market, but the question today is how the financial crisis in Europe will impact the economic outlook for the medium and long term.

By Marc Stegeman

As governments continue to work to unfreeze the flow of credit to businesses and consumers, Europe is bracing for hard times ahead.

“For Europe, the advance third-quarter numbers show a further contraction in output beyond the second quarter,” said Bart van Ark, chief economist of The Conference Board. “Growth for the year 2008 as a whole may still come out reasonably well for the Euro Area, but that’s only because Europe – and particularly Germany – started off on a strong first quarter this year,” The big question, he added, is whether a lack of flexibility in European markets, for example in labor markets and wage contracts, which still reflect “better times”, could delay a recovery beyond a U.S. revival. “For now,” Dr. van Ark predicts, “we project Euro Area growth between zero to 0.5% growth for 2009, which would be slightly better than in the U.S., but the risks are more on the downside than on the upside.”

This view is echoed by many economists.

“I’m a bit gloomy on the Euro Area and European economy as a whole,” said Jean-Claude Manini, recently appointed economist for The Conference Board Europe. “Worse-than-expected data have unfolded at a rapid pace recently, and the recession seems to be a fact now. The debate has clearly evolved toward whether the economic recovery will be in the shape of a V, a U or an L.”

The crisis began over a year ago as falling housing prices in the U.S. exposed unseen risks inherent in complex, new securities that had been designed specifically to protect against risky, or “subprime”, mortgages. Concern over European banks’ exposure to these “toxic” U.S. assets quickly exploded into a full-fledged crisis of confidence, with banks refusing to lend funds to one another and national governments scrambling to assuage growing fears among financial institutions, businesses and the general public.

Economic indicators throughout the world have been steadily trending lower ever since. The U.S. reported a contraction of 0.3% in output for the third quarter, a result that was widely expected given the deepening crisis in the financial markets since mid-September.

The Conference Board Appoints New European Economist

The Conference Board has named Jean-Claude Manini as European Economist. Mr. Manini has a background in financial markets and will be instrumental in helping The Conference Board develop its European economic indices and reports.

See back page for interview with Mr. Manini.

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European Central Bank President Jean-Claude Trichet and U.S. Treasury Secretary Henry M. Paulson, Jr.

"I would expect this number to be even somewhat downwardly adjusted once the more final numbers for September will have come in," said Dr. van Ark. "The fourth quarter is not going to look pretty and may see U.S. output decline by up to 2% (on an annualized basis). It is not clear that we already see the bottom of the housing market, and it will be a while before the government measures recently taken begin to unfreeze the credit flow to consumers and business. This means the consumer will continue to cut spending, despite the upcoming holiday season. Greater reliance on cash means that the size of purchases will decline. Businesses will find it hard to get approval for new investment plans, and will want to wait a little more anyway before jumping on the new opportunities. We therefore expect no signs of recovery before the middle of 2009. For the year as a whole, 2008 would still post positive growth of more than 1%, but for 2009 we are in for a standstill or a contraction, depending on when the recovery starts."

Need for more government intervention?

Over the past decades, a broad consensus emerged around the concept that free markets are the best drivers of economic growth, and that government regulation should be kept to a minimum in order to allow new product markets to develop and capital markets to function optimally. The current crisis is testing the limits of this view, prompting many to raise the question of whether greater government intervention may be necessary, at least in the short term. Indeed, this is already happening in Europe as governments begin to take ownership of private banks

As consumption continues to slow and unemployment rises, governments may need to create jobs and stimulate spending in ways that would have been considered unthinkable as recently as a few months ago. The question for Europe is how to build those structures that will allow solutions to be designed and implemented.

"Government intervention on both sides of the Atlantic has initially been strongly focused on providing stability to the financial markets and restoring confidence," said Dr. van Ark. "The U.S. administration has been more reluctant than European governments to provide comprehensive guarantees to directly support the balance sheets of all banks and buy partial or full stakes in banks. The speed at which events evolved, however, has led the

U.S. to follow suit. But there are big questions on how these interventions will work out. What is this going to mean, for example, for competition in financial markets, particularly an issue in the smaller European economies? How can market mechanisms be restored? And what about demands or pressures for government support to non-financial firms that may get in trouble?"

'Difficult economic environment'

Among all the questions being asked, one thing is clear: the future will be more difficult.

"We will clearly be facing a more difficult economic environment over the next 2 to 3 years," said Thomas Bernt Henriksen, director of The Conference Board's European Council of Economists. "An old rule says that a financial crisis lasts between 12 and 16 months, with the last few months showing extreme tensions and extreme valuations. We've been in this crisis for about 14 months and we are now seeing extreme tensions and valuations. The question is what happens afterwards. What kind of downturn will we have after the financial crisis is over?"

A study by the International Monetary Fund shows that economic downturns are twice as deep when they are preceded by a period of financial stress. "We are entering a transition from a financial crisis to an economic crisis," Mr. Henriksen said. "The financial crisis will not last forever. At some point, we will have to look at it as an economic issue. This transition period can take 4 to 8 to 12 months. But by then the problem of the banking sector will be behind us, and then we will have to look at the economic challenges. From a policy perspective, this is very important. The whole key here is to see this as a transition."

The outlook

What should businesses expect during this transition period? First, higher borrowing costs – and this despite lower government interest rates as central banks seek to push liquidity into the system. Second, rising unemployment, as the lack of liquidity forces companies to cut back. Third, higher inflation over the medium to long term.

"We have to accept that global inflation will on balance be higher than most people might otherwise have expected," Mr. Henriksen said. "We can hope to keep inflation between 2 and 5%, but this may be the price we have to pay for the crisis. Debt levels in the Western world are higher than is sustainable, and paying down that debt will be very hard. But here inflation will help. If you have 5% inflation over five years, that will cut 25% of your debt. The challenge for Europe will be to work out the balance. Europe may not be as exposed as the U.S., and this may help keep inflation in check in Europe."

A time of crisis is also a time of opportunity. "In these periods of budget cuts and the need for cost-savings, it is difficult for business leaders and executives to keep focused on innovation and productivity, which are the drivers of future growth," Dr. van Ark said. "R&D projects and other innovation programs may need to be shelved, and past investments in human capital, such as training of the labor force in higher skills, may erode if not kept up to date. Nevertheless, the opportunities for new applications and markets often arise out of times of crisis. So competitiveness and long-term growth should not be lost from sight."

Grim Outlook for the Global Economy

By Thomas Bernt Henriksen and Lluvia Ellison-Morales



The Conference Board's European Council of Economists met in Barcelona on the 16 and 17 of October to discuss their perspectives on the future projections of the economy.

The recent financial turmoil that hit the markets in the United States sent negative reverberations throughout the international system. Though the U.S. housing bubble in 2007 triggered the crisis, this is a spawn from a decade of unregulated mortgage practices and exploitation of the credit market. As the world's leading mortgage banks crumbled and stocks plunged, economists all over the globe struggled to make sense of the situation and predict its future steps. Using the Conference Board as a discussion platform, members of the European Economists Council met in Barcelona on the 16 and 17 October to answer the question on everyone's mind, "What's next?"



Thomas Henriksen,
director of the European
Council of Economists.

According to the Council, with oil prices dropping below \$60, this is a clear signal that oil markets are expecting a severe and protracted recession in the global economy. Though oil prices have been exacerbated by forced liquidations in the oil futures market, the result will be a slower global growth and a rise in physical oil supply.

With economic trends in the European and Global economy pointing to a sharp deceleration in economic activity, the shocks emanating from the financial sector feed through to the real economy. Projections revealed expectations to be lagging in the ongoing deterioration of the economic climate as a result of the crisis in money and credit markets. This sharp deterioration of the economic outlook has significantly increased the risk of a strong deflationary impulse to the global economy, which needs to be countered by monetary policy, fiscal policy and continued efforts to contain the financial crisis.

One of the key conclusions from the meeting of the Economists Council is that the measures taken to stabilise markets need to be made to work over the very short term in order to avoid a deep and protracted downturn in the global economy. Though massive measures have been taken, companies already see their profit margins coming under severe pressure from falling commodity prices and declining demand.

The slowdown in consumption, which is already visible in the U.S. and Europe, will be accelerated, once unemployment starts to rise. Calculations done by one of the members of the Economists Council revealed a negative growth risk in the Euro Area in 2009. In addition, there was a consensus of a below 3 percent growth in the global economy. Traditionally, a global growth rate of below 3 percent has been defined as a recession.

According to the European Economists Council, in order to ease the flow of money and unblock credit markets, monetary policy has a fundamental role in fighting the global deflationary pressures with further financial injections, above all in Europe. While there was some criticism regarding the European Central Bank's (ECB) actions in July to hike up interest rates, the European Council of Economists fully supported the ECB's decision in October to cut rates. The Council expects further significant rate cuts in the coming months.



Jean-Claude Manini Discusses The Current Crisis in Europe

The Conference Board has named Jean-Claude Manini as economist for Europe. With a background in financial markets, Mr. Manini brings key expertise at a critical moment for Europe. Board Europe spoke with Mr. Manini to discuss the financial crisis and how The Conference Board can help business executives prepare for the future.



Jean-Claude Manini

In terms of the economic fundamentals, is the gloomy mood in Europe warranted?

JCM: I'm involved in the markets on a daily basis, so it is hard to see a bright spot right now. I still think that we are in a significant slowdown, if I look at the indicators, but the fundamentals of the European economy are not as bad as some feel. This is something of an article of faith. Visibility is very low right now. Things are moving very quickly and there is not enough data yet to assess the duration and the depth of the current contraction.

In your opinion, what are the best-case/ worst-case scenarios?

The West has accumulated a huge amount of debt, so it is very important to contain the crisis. The key is confidence. The best-case scenario is that we restore confidence quickly enough, that the money markets begin to work smoothly again and that we will remain in a slow growth environment for the rest of the year, with the possibility of improvement in 2009. In the worst case, the money markets remain frozen and the economy may slow down more and generate a recession. The real issue is that the credit machine in the economy has stalled. There is no liquidity. Even companies with good backlogs are having trouble financing their operations.

Does the European Union have the tools to deal with this type of crisis?

The European Union, as an organization, does not have the tools. Everything is happening at national level, so what we need is coordination. But the speed with which policy makers are reacting is gather pace, it is accelerating. We can take confidence in that.

What can The Conference Board do to help its member companies?

Our main function is to help people to understand what is happening. It is not so much about forecasting the future but to understand the current situation. Right now there is low visibility and high volatility and it is hard to find out what is happening and what to do in terms of inventory management plans, capital plans and the like. You cannot take tactical or strategy decisions without a clear enough view of the economic context.

The Conference Board is now going to publish more broadly a series of European economic indicators that are comparable to those it provides for the U.S. economy. Is this the kind of help you mean?

The Conference Board's leading indicators for Europe tell us a lot. In the Euro Area, the leading indicator described a slow down a lot earlier than a lot of other indicators. At The Conference Board, we are working on a continuing basis to improve the

analysis of these indicators, trying to extract a maximum of information from each component and better understand their contribution to the indicator. This is really where we provide enormous value to our members. Firstly, we publish indicators that give a broad general direction, but then we also help you to analyze them, to understand what they mean for you. All of The Conference Board indicators use a common method of calculation, so they provide a valuable tool for comparing economic performance in Europe and the U.S. and elsewhere.

Is there any upside potential to this financial crisis?

There are always a lot of opportunities in such cases. The most obvious is that there are assets that are cheap. If you have cash on your balance sheet or can finance the purchase, then there are opportunities to expand or increase in size. A lot of Japanese companies have strong balance sheets and cash positions, so they are looking for deals. This is the most obvious thing. Beyond that, if you have the means to invest in innovation and technology to improve your productivity, then you can become more competitive. In a slowdown, competition increases because everyone is struggling. So the more competitive you can be, the better. But this is often hard for managers to accept.