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THE SECOND PHASE OF THE EVOLVING FINANCIAL CRISIS AND THE GROWING PROBABILITY OF NEXT RECESSION

1. INTRODUCTION

When the global crisis of financial markets set off as of mid-2007, it was difficult to foresee that the crisis would have substantial ability to evolve and that turbulence of financial markets (of the US mortgage market especially) represented only its first, initial phase. As the five-year period 2007–2011 went on, two parallel phenomena could be seen more and more clearly. First, the evolving financial crisis, moving from the territory of investment banks and other financial institutions into the domain of sovereign debt. Second, succeeding phases in the atypical business cycle, with a serious threat of the next recession coming after a very short period of sluggish expansion. These two phenomena developed simultaneously, overlapped to some extent and had a mutual impact on each other, but to each of them a certain autonomy could be also attributed.

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2. SOME REMARKS ON THE SECOND PHASE OF THE EVOLVING FINANCIAL CRISIS

Already on the turn of 2006/2007 many economies were heading towards cyclical contraction following exceptional world growth in the period of 2003–2006. In the summer of 2007 turbulence of the US mortgage market has sparked off a severe financial market crisis which, just one year later – since the summer of 2008 – significantly accelerated and deepened the foreseeable recession. The worst of this recession came in the first half of 2009.

Until the turn of 2008/2009, fiscal activism did not enjoy a very good image. Among economists, the opinion predominated that the best instrument for overcoming a recession is monetary policy. However, in view of the depth of the 2008/2009 recession and the poor operation of the monetary transmission mechanism, many governments decided to implement fiscal stimulus policies as an alternative strategy to counteract the recession and strengthen a recovery of confidence.

Fiscal program measures contributed to a gradual recovery which started in the second half of 2009. But, the governments which put forward these measures significantly increased fiscal deficits and did not avoid huge increases in government borrowing, thus increasing the public debt and raising doubts about their fiscal sustainability. An adverse reaction in financial markets – strong increase of yields of many countries' government bonds – was only a matter of time. The deterioration of public deficits in selected countries at the turn of 2008/2009 is shown in Table 1.

Table 1. The public deficits 2007–2010

	2007	2008	2009	2010
€uro Area	0.7%	2.0%	6.3%	6.0%
USA	2.9%	6.3%	11.3%	10.5%
Japan	2.4%	2.1%	7.1%	7.7%

Source: Eurostat, OECD.

In consequence, at the turn of 2009/2010, the financial markets were slowly getting back to normal, but their crisis transformed into a sovereign debt crisis. The last one could be classified as a second phase of the evolving, general financial crisis. Simultaneously, the recession phase ended in the second half of 2009. It opened the way to sluggish expansion (with modest growth and high unemployment).

The sovereign debt crisis which fully developed in 2011, meant the inability of some governments to borrow at reasonable interest rates. Many investors were unlikely to buy the debt of the small peripheral countries (Greece, Ireland and Portugal) and numerous funds were reluctant to buy the debt of Spain and

Italy, too (Italy could still borrow in public markets, but only at rates that seemed unsustainable). These troubled countries' spread with German debt, which has become the reference point for the entire European region, and American Treasuries, shot up to the highest levels since the euro came into being. The public debt spreads (ten year government bonds) with German Bunds and US Treasuries on Wednesday, October 19, 2011, are shown in Table 2.

Table 2. Bonds – ten year government spreads vs Bunds and Treasuries

Country	Bid Yield	Spread vs Bund	Spread vs US Treasuries
Greece	25.10	+23.02	+22.94
Portugal	12.21	+10.13	+10.05
Ireland	8.70	+ 6.63	+ 6.54
Italy	5.92	+ 3.85	+ 3.76
Spain	5.39	+ 3.32	+ 3.23
Belgium	4.46	+ 2.38	+ 2.30
France	3.20	+ 1.12	+ 1.04

Source: ThomsonReuters.

It is worth noticing that huge spreads in the eurozone debt markets are at complete variance with the theoretical framework of Optimum Currency Area (OCA) created by R.A. Mundell and J.C. Ingram. According to these authors, the evenness of the long-term interest rates represents one of the basic features of Optimum Currency Area and excessive diversity in this realm indicates the lack of proper integration of financial markets which is required to delineate OCA.[1]

The sluggish expansion which extended since mid-2009, seemed to approach its end in the summer of 2011. The significant deterioration of many economic activity indicators could be observed and the main indicator, gross national product (GDP), started to record diminishing advances (especially in Europe). In most of the advanced economies the growth forecasts for 2012-2013 were tending to be lowered and fears rose that the developed world might be tipping back into recession.

Two recessions narrowly separated by short (about 20-22 months) and sluggish expansion represent a rather atypical business cycle, but such occurrence on no account could be perceived as unprecedented. Since 1929 the National Bureau of Economic Research (NBER) identified at least three episodes when new recession came after a short-lived expansion (see Table 3).

[1] See Ingram, J.C., *Comment – The Currency Area Problem,* in: *Monetary Problems of the International Economy* (Mundell, R.A., Swoboda, A.K., eds.), Chicago 1970.

Table 3. Duration of expansion and contraction phases (in months)

Date the recession started	Duration of preceding expansion phase	Duration of recession phase
September 1929	21	43
May 1960	24	10
August 1981	12	16

Source: NBER.

3. CONCLUDING REMARKS

Probability of the next recession of unknown depth and duration is not the only uncertainty regarding the medium-term outlook which emerged at the end of 2011. At the same time, the serious sovereign debt crisis that came from the financial markets crisis starting in 2007, seemingly began to move into the territory of central banks. Because of this, the third phase of the global financial crisis could be constituted by the undermined credibility of central banks and the elevated inflation.

The risk that the evolving financial crisis would eventually encompass central banks results from the fact that troubled governments seem keen to pass their debt burden exactly in this direction. During the two-year period 2010–2011 monetizing debt became a broadly used tool of macroeconomic policy. The Bank of England launched at least two rounds of buying governments bonds with newly created money, known as quantitative easing (QE). The US Federal Reserve made two extensive attempts at quantitative easing before beginning a new policy called Operation Twist. Even the European Central Bank, which remains faithful to German tradition of conservative central banking, decided to buy – in the secondary market – the bonds of Italy and Spain, just after making significant purchases of the Greek bonds.

The extraordinary actions of central banks have resulted in big expansion of their balance sheets – those of the US Federal Reserve and Bank of England have tripled, while the ECB's has almost doubled. This extensive monetization of public debts didn't create excessive inflationary pressures at the time of modest growth and subdued credit expansion. Financial institutions that sold sovereign bonds were in search of a safe asset, and this was primarily central bank money. That money was accumulated in a form of additional liquidity and was not used to expand credit – dynamic of money supply, described by the M3 aggregate, stood at relatively low levels and did not lead to a notable rise in inflation. However, it is not clear what could be the effect of the heightened central banks' balance sheets in a longer term. Probably, at the end of 2011, it was still not the time to profile the

"exit strategies", but neither was it the time to neglect the risk of high inflation some future day. Eventually, the likely route out of the sovereign debt crisis (the second phase of the financial crisis) could be through inflation (the third phase of the financial crisis).

The combination of weakening economic activity and central banks reaching the limits of their own credibility created an environment with vast amounts of headline risks. Unfortunately, this combination gives the impression of being an unavoidable component of the nearest future.