



Credit crisis: the next step

As economic turmoil on the world stage drags on, some experts are of the stark view that a global recession looms, writes John Walsh.

The credit market crisis is taking much longer to unfold than had previously been expected, with some commentators now claiming that the fallout could push the global economy into a severe recession.

The world economy is still robust, but in view of the opaque nature of the credit market instruments at the root of the credit market crisis, there is a growing view that there could be harsh knock-on effects for the real economy.

In his latest commentary, Wolfgang Munchau, a director of the economic consultancy firm Euro Intelligence and an associate editor with the *Financial Times*, paints one of the bleakest outlooks yet of how the credit market crisis is going to pan out. "My own guess is that we are about 10% through this, in terms of timing, less than 10% in terms of costs to the financial sector and much less in terms of economic impact."

He argues that there are four economic shocks looming: a worsening of the credit market crisis; the collapse in the dollar's exchange rate; the US economy hitting the rocks; and a rise in global inflation.

If the US were to slip into a recession, that could coincide with rising inflation. And if that were to happen, then the US economy would hit a period of "stagflation" – stagnant growth with high inflation. The US Federal Reserve would be hamstrung in its efforts to stoke economic activity. Moreover, if the largest economy in the world were to slide into recession, with the dollar plunging to a rate of close to \$1.70 against the euro – as one leading foreign exchange expert is now claiming – then that would trigger a second round of corporate bankruptcies that would hammer real economic growth.

But as with any crisis as complex as what is currently sweeping through the markets, there is fair degree of dissonance between experts on what happens from here. Alan

Ahearne, vice dean at NUI Galway's business school and a former senior economist at the US Federal Reserve, says it is too early to make forecasts as definitive as Munchau's.

"It is very unclear what is happening so I am not sure how he can come up with such a strong opinion. It is very hard to know because we don't know the extent of the crisis. He is clearly thinking that the losses are going to be greater than expected. It is true that, over the past few weeks, estimates have gone up of how hard this is going to hit financial institutions. Initially Citibank had estimates of \$3bn, now this has gone up to \$10bn. Another thing that is happening is that the US housing market continues to get worse, so then you'd expect the losses to mount. How that affects the real economy is still unclear: one channel would be through higher spreads. The banks will charge higher interest rates even without central banks increasing rates. At the moment, all the evidence we have is anecdotal about banks cutting back on credit," says Ahearne.

He argues that it will be impossible to say with any great confidence what will happen next until banks and relevant financial institutions post year-end results that show the provenance and extent of all losses and how these are going to be accounted for. "But at the moment, the lack of transparency is a huge problem," says Ahearne.

The US economy has been the engine of world growth for well over the past decade. It has soaked up exports from around the world, particularly Asia. Munchau argues that US financial institutions will be disproportionately hit by the credit crisis which, in turn, will presage a much greater impact on the economy.

Ahearne claims the impact could be far worse in Europe because the US will get bailed out by a weaker currency, which will

help export led-growth. And he doesn't see the US economy entering into a period of stagflation.

"If you look at financial market indicators, they suggest that people's expectations of inflation have risen a bit but not much. Stagflation is usually caused by a supply shock. The classic stagflation was back in the 1970s, when we had a big increase in oil prices and it dragged the economy into a recession. The credit crisis is more likely to be a shock to demand or spending that has the potential to drag the economy into recession. That would cause inflation to moderate which, in turn, would allow the Federal Reserve to cut interest rates. In the background, we have oil prices which complicates things. It may be a difficult trade-off."

Ahearne argues that if the global economy stays strong then that will help mitigate the worst effects of the credit crisis. The biggest worry is for countries that have relied on cheap credit and low interest rates for their growth over the past few years: "Because if the credit crisis continues and bank lending starts to contract, then the countries that relied on loose credit for growth are the most exposed and would be the most affected. That includes Ireland." ■

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