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Summary

1) The world is heading into a severe slump, with declining output in the near term and no clear turnaround in sight. We forecast a contraction of minus 1 percent in the world economy in 2009 (on a Q4-to-Q4 basis) and no recovery on the horizon, so worldwide 2010 will be at best "flat" relative to 2009. The most likely outcome is not a V-shaped recovery (which is the current official consensus) or a U-shaped recovery (which is closer to the private sector consensus), but rather an L, in which there is a steep fall and then a struggle to recover. A "lost decade" for the world economy is quite possible.
2) Consumers and businesses virtually everywhere are trying to "rebuild their balance sheets," which means they want to save more and spend less. Lower asset prices mean large holes in public and private pension plans; this further strengthens the incentive to save more now.
3) Governments have only a limited ability to offset this decrease in private demand through fiscal stimulus. Even the most prudent governments in industrialized countries did not run sufficiently countercyclical fiscal policy during the boom and now face balance sheet constraints. In the US, the budget deficit is approaching a trajectory that is sustainable only if rapid growth returns in 2010. If the recession persists, the government will face a hard choice between the stimulus needed to aid the economy and the austerity needed to ensure fiscal sustainability. State and local governments risk default, and will either receive more assistance or have to cut back further on their spending.
4) The still-forthcoming policy attempts to deal with banking system problems in the US will be insufficiently forceful. Current indications suggest the Obama Administration currently is unwilling to take on the large banks in anything approach a decisive manner; the prevailing approach will remain one of "muddling through". Large banks will remain "too big to fail," but without a decisive solution lending will remain anemic.
5) Compounding these problems is a serious test for the Eurozone: financial market pressure on Greece, Ireland and Italy is mounting; Portugal and Spain are also likely to be affected. The global financial sector weakness has become a potential fiscal issue of the first order in these countries. This will lead to another round of bailouts in Europe, this time for weaker sovereigns in the Eurozone. As a result, governments will feel the need to attempt precautionary austerity instead of spending on fiscal stimulus.
6) The emerging markets crisis is deepening, particularly as global trade contracts and there are immediate effects on both corporates and the financial system. Currency collapse and debt default will be averted only by fiscal austerity. The current IMF/EU strategy is to protect creditors fully with programs that do not allow for nominal exchange rate depreciation. This approach increases the degree of contraction and social costs faced by domestic residents, while also making economic recovery more difficult. As East-Central Europe slips into deeper recession, there are severe negative consequences for West European banks with a high exposure to the region.

7) A rapid return to growth requires more expansionary monetary policy, and in all likelihood this needs to be led by the United States. But the Federal Reserve has not committed itself to this strategy. The European Central Bank still fails to recognize the seriousness of the economic situation. The Bank of England is embarked on a full-fledged anti-deflation policy, but economic prospects in the UK still remain dire.
8) The European push to re-regulate, which is the focus of the G20 intergovernmental process (with the next summit set for April 2), could lead to a potentially dangerous procyclical set of policies that can exacerbate the downturn and prolong the recovery. There is currently nothing on the G20 agenda that will help slow the global decline and start a recovery. The Obama Administration will have a hard time bringing its G20 partners to a more pro-recovery policy stance; the push for a fiscal stimulus is at odds with the budget realities in a rapidly slowing Europe.
9) Capital will continue to flow into US government securities, primarily due to lack of good alternatives around the world. However, the slowing global economy will reduce the current account surpluses of China, Japan, and oil exporters, and this will further tend to push up interest rates on longer-term US government debt.

Overview

The current official consensus view (e.g., as seen in the World Bank's Global Economic Prospects, the OECD's leading indicators, or the latest IMF World Economic Outlook) is that we are having a serious downturn, with annualized growth for the fourth quarter in the US at minus 6% and a presumed steep decline in the first quarter of 2009. But the consensus is that a recovery will be underway by late 2009 in the US and shortly thereafter in the Eurozone. Fed Chairman Bernanke recently predicted growth of 2.5-3.3% in 2010 and 3.8-5.0% in 2011. This will help bring up growth in emerging markets and developing countries, so by 2010 global growth will be moving back towards its 2006-2007 rates.

Our baseline view is considerably more negative. While we agree that a rapid fall is underway and the speed of this is unusual, we do not yet see the mechanisms through which a turnaround occurs. In fact, in our baseline view there is considerably more decline in global output already in the works and, once the situation stabilizes, it is hard to see how a recovery can easily be sustained.

The consensus view focuses on disruptions to the supply of credit and recognizes official attempts to support this supply. In contrast, we emphasize that the crisis of confidence from mid-September has now had profound effects on the demand for credit and its counterpart, desired savings, everywhere in the world.

To explain our position, we first briefly review the background to today's situation. We then review both the current situation and the likely prognosis for policy in major economies and for key categories of countries. While a great deal remains uncertain about economic outcomes, much of the likely policy mix around the world has become clearer. We conclude by reviewing the prospects for sustained growth and linking the likely vulnerabilities to structural weaknesses in the global system, including both the role played by the financial sector almost everywhere and the way in which countries' financial sectors interact. In the end we come full circle - tomorrow's dangers can be linked directly back to the underlying causes of today's crisis.

Understanding the Crisis

The precipitating cause of today's global recession was a severe "credit crisis," but one that is frequently misunderstood in several ways. While the US housing bubble played a role in the formation of the crisis and continued housing problems remain an issue, the boom was and the bust is much broader. This was a synchronized debt-financed global boom, facilitated by flows of capital around the world.

In particular, while the US boom was at the epicenter of the crisis, regulated European financial institutions played a critical role in facilitating the boom and spreading the adverse consequences worldwide. And, like the US, some European governments ran relatively irresponsible fiscal policies during the boom, making them now unable to bail out their financial systems without creating concerns about sovereign solvency.

The flow of capital from countries with current account surpluses (e.g., China) contributed to the buildup of vulnerabilities. By managing its currency, China effectively suppressed domestic demand, allowing it to build up a large current account surplus. Instead of selling dollars on foreign currency markets (which would have depressed the dollar), it chose to buy large amounts of Treasury and agency securities, increasing the supply of lending to the U.S. economy and pushing down interest rates.

An important role was also played by banks from countries without surpluses, such as the Eurozone as a whole; that is, the gross flow of capital into risky opportunities in the US was just as important as the net flow of capital.

The boom exacerbated financial system vulnerability everywhere. That vulnerability made possible a severe loss of confidence in the credit system when Lehman collapsed in September 2008. The immediate consequence was a fall in the supply of credit, but this rapidly translated into a fall in demand for credit. People and firms want to pay down their debts and increase their precautionary savings; in the U.S., the household savings rate has climbed from almost nothing to 5%.

There is no "right" level of debt, so we don't know where "deleveraging" (i.e., the fall in demand for and supply of credit) will end. Leverage levels are very hard for policy to affect directly, as they result from millions of decentralized decisions about how much people borrow. Anyone with high levels of debt in any market economy is now re-evaluating how much debt is reasonable for the medium-term.

As a result, while attempts to clean up and recapitalize the US and European financial systems make sense – and are needed to support any eventual recovery – this will not immediately stop the process of financial contraction and economic decline. Fiscal stimulus, similarly, can soften the blow of the recession, but will not directly address the underlying problems, and many countries are constrained by high debt levels. A dramatic shift in the stance of monetary policy is required in almost all industrialized countries and emerging markets, but most countries have been slow to recognize this need.

The Global Situation Today

United States

Perhaps the most fundamental barrier to economic recovery in the US is the weakness of balance sheets in the private sector. Households did not save much since the mid-1990s and reduced their savings further this decade, in part because of the increase in house prices; this was the counterpart of the large increase in the US current account deficit. Desired household saving is now increasing, at the same time that the corporate sector is cutting back on investments. The main dynamic is a fall in credit demand rather than constraints on credit supply in the US. Even entities with deep pockets, strong balance sheets and long investment horizons (e.g., universities, private equity) are cutting back on spending and trying to strengthen their balance sheets. This desire to save is creating the economic contraction we see all around us.

There are three major categories of potential policy responses: fiscal, financial, and monetary. However, each of them faces real constraints.

The fiscal stimulus package passed in February is a first step. However, it is too small to close the projected output gap under any scenario; at best, it will shave a couple of percentage points off of unemployment, which will increase further before falling. Further, large portions of the stimulus were diverted into areas that will provide no economic benefit. Most obviously, the decision to "fix" the Alternative Minimum Tax was already assumed, and hence it will have no contribution to economic recovery. If our expectations regarding the overall economy are correct, we will need another large stimulus package later in 2009; unfortunately, it is likely that the political climate will make such a package difficult if not impossible to pass.

Besides politics, the main constraint on fiscal stimulus is the US balance sheet. The US balance sheet is strong relative to most other industrialized countries - private sector holdings of government debt are around 40% of GDP - and US government debt remains the ultimate safe haven. But with increasing Social Security and Medicare payments in the medium term, the national debt will only increase for the foreseeable future. The underlying problem is that fiscal policy was not sufficiently counter-cyclical during the boom. After paying for the economic recovery and cleaning up the financial system (which we expect to cost 10-20% of GDP), government debt could easily be 70% of GDP. The net effect of our financial fiasco is to push us towards European-style government debt levels, and this obviously presses us further to reform (i.e., spend less on) Social Security and Medicare. And we need to make sure we don't have another fiasco of similar magnitude any time in the near future.

Second, financial sector policy has not been encouraging. Despite a series of efforts that were both heroic and chaotic, the banking sector today is roughly in the same state it was in after the collapse of Lehman in September: investors do not trust bank balance sheets, further writedowns are expected, and stock prices are above zero mainly because of the option value of a successful government rescue. The Financial Stability Plan announced by Treasury Secretary Geithner one month ago promises to use stress tests to determine once and for all which banks are solvent; however, as many economists have pointed out, the "worst case" scenario in the stress test is not particularly pessimistic. In addition, comments by administration officials seem to imply that no banks will fail the stress tests, which has reduced the public credibility of the exercise.

In the meantime, the administration's actions imply that the overall plan is to continue providing money to financial institutions on an as-needed basis in their current form. The Citigroup conversion from preferred to common shares, the latest AIG bailout, and the plan to offer future capital in convertible preferred shares are all consistent with an overall intention to keep these institutions in their current form, providing enough capital to keep them afloat, while attempting to minimize government ownership and control. Or, in the more direct words of Paul Krugman, "The actual plan seems to be to keep the banks semi-alive by implicitly guaranteeing their liabilities and dribbling in money as necessary, all the while proclaiming that they're adequately capitalized — and hope that things turn up."

Most economists are agreed that more decisive action is necessary, although we differ on the form of that action. Broadly speaking, the main options being proposed are: (a) overpay for the banks' unwanted assets (or insure them at low cost, which amounts to the same thing), and give them enough cheap capital to ensure their health in their current form; or (b) determine which banks can survive a deep and long recession, declare the others insolvent, take them into government conservatorship, clean them up, and reprivatize them when the market allows. Both of these will be politically difficult.

The Treasury plan to form a public-private partnership to buy banks' toxic assets is simply a version of (a), using non-recourse loans from the Federal Reserve to encourage investors to overpay for assets. But until there is a plan that is sufficiently aggressive and well-funded to inspire confidence, the banking sector will remain in its current state of limbo. And in the meantime, a relatively complex and opaque approach to what is really a simple problem – the chronic lack of capital in the banking system – could well generate the (accurate) impression that the bankers are availing themselves of a nontransparent approach and in effect stealing resources from the state. This is the kind of behavior more commonly seen at such scale in a troubled developing economy, and while it does not preclude episodes of growth, it is usually associated with repeated crises, widening inequality and – eventually – social/political instability.

We expect that the government will follow the "stress tests" with a medium-scale bank recapitalization and launch some form of the public-private asset-buying scheme. This will increase confidence in the banking sector in the short term - as investors feel more confident about bank liabilities - but this effect will fade in a few months as it becomes evident that the banking sector still suffers from the root problems it faces today.

If, by good fortune, the US and global recession ends in the second half of this year, then the difficulties of the banking sector may be manageable. However, we expect to see worse outcomes in 2009 than currently expected by the consensus. Such outcomes are not yet fully reflected in asset prices, and the problems for banks around the world will mount. We will need to readdress the need to fully clean up the banks, but making progress with this depends on a political willingness to take on the powerful banking lobby.

Third, monetary policy can still make a difference. In particular, we still risk entering a deflationary spiral with falling prices and downward pressure on nominal wages. Inflation expectations have become positive once again, and the Federal Reserve has committed to a mild form of inflation targeting (at 2%). However, if the economy continues to deteriorate, inflation will fall short of expectations and the risk of deflation will increase.

We believe a moderate level of inflation would be beneficial in this environment and that generating that inflation should be a goal of monetary policy, perhaps by talking down the dollar, or by engaging in the forms of quantitative easing that Fed Chairman Bernanke has discussed. We expect that the Fed will move toward a more explicitly expansionary monetary policy later this year in the face of a continued recession. This will weaken the dollar and put pressure on other countries to follow suit - expansionary monetary policy is infectious in a way that expansionary fiscal policy is not. The net effect on the dollar, of course, depends on how bad the situation is in other regions.

Western Europe

Major Western European countries, beginning with the UK, have been severely affected by the global recession. The composite of forecasts tracked by Bloomberg predicts a contraction of 3% in GDP not only for the UK, whose housing bubble and degree of dependence on the financial sector were arguably greater than in the US, but even in Germany, whose exports are under severe pressure. The Eurozone as a whole is expected to contract by over 2% during 2009, and grow by 0.7% in 2010. Again, we feel the 2010 forecast is optimistic, because the mechanism for the turnaround is missing.

The UK has already seen a second round of bank nationalization (increases in government ownership), and has adopted an explicitly expansionary monetary policy. The UK is an AAA-rated sovereign with its housing market in a nose dive, overextended (and apparently mismanaged) major banks, and a government on its way to guaranteeing all financial liabilities and directing the flow of credit moving forward. The emerging strategy is based more on depreciating the pound - which is contributing to tensions with other European countries - and surprising people with inflation than on fully-funded bank recapitalization. Additional fiscal stimulus increasingly looks irrelevant and perhaps even destabilizing. The yield on 10-year government bonds is, of course rising - now over 3.5%.

Pressures on individual governments are even greater in some parts of the Eurozone, where individual countries do not have control over monetary policy. Greece faces the most immediate problems, as demonstrated both by widening credit default swap spreads and increasing spreads of Greek bonds over German government bonds, with Ireland in second place. In general, markets are repricing the risk of lending to a wide range of governments.

The need to bail out struggling financial sectors only increases this risk. If the U.S. ever makes a definitive move to protect its banking system (either by recapitalizing existing banks, or by taking them over), this will put pressure on other rich countries to guarantee their banking systems. This effectively converts a private sector solvency crisis into a public sector solvency crisis. Some countries will be able to take on this additional burden; some will not.

The reaction that one hears from senior European officials and richer Eurozone countries is that Greece (and Spain and Italy and others) should deal with their fiscal problems themselves. However, in our baseline view, we expect that in the end Greece will receive a bailout from other Eurozone countries (and probably from the EU). With or without a bailout, however, Greece and other weaker euro sovereigns will need to implement fiscal austerity. The net result is less fiscal stimulus than would otherwise be possible, and in fact there is a move to austerity among stronger euro sovereigns as a signal. Governments will therefore be unable to dissave enough to offset the increase in private sector savings. Germany in particular will do whatever it takes to maintain a reputation for fiscal prudence.

At the same time, however, the deep recession in the Eurozone is putting pressure on the European Central Bank (ECB) to loosen its policies. We expect the ECB will continue to be slow to respond. The ECB's decision-making process seeks consensus and some key members are still more worried about inflation down the road than deflation today. The ECB's benchmark rate is still at 1.5%. Eventually the ECB will catch up, but not before there has been considerable further slowing in the Eurozone.

The current consensus forecast is that the Eurozone will start to recover in mid-2009 and be well on its way to achieving potential growth rates again by early 2010. This seems quite implausible as a baseline.

Japan

Japan, with its export-dependent economy, has been hit harder by the global recession than any other G7 country. Its economy is expected to contract 5.9% in 2009. Exports already fell by 35% from December 2007 to December 2008, hurt not only be weakening global demand but also by the appreciation of the yen. Businesses are likely to want to strengthen their balance sheets further and households with already-high savings rates are unlikely to go on a spending spree. As a result of these factors, the Bank of Japan recently predicted that the country will suffer two years of economic contraction and deflation.

The government's balance sheet is weak, but it is funded domestically (in yen, willingly bought by households), so there is room for further fiscal expansion. However, this is unlikely to come quickly.

The ability of the Japanese central bank to create inflation has proved limited. Once deflationary expectations are established, these are hard to break. Inflation expectations are still negative in both the medium and the long term. This difficulty in creating positive inflation expectations will make it harder for any fiscal stimulus to be successful in restarting the economy. Overall, it is difficult to see Japan being a major contributor to global growth.

China

The current crisis has shown that China's economy is far from invulnerable. The 6.8% year-over-year growth rate in Q4 may have implied that the quarter-over-quarter growth rate was around zero, and forecasts for 2009 are in the 6-8% range - below the level commonly understood as the minimum to avoid growth in unemployment.

The major increase in savings by China over the past 10 years was primarily due to high profits in the corporate sector. Chinese growth now seems likely to slow sharply, and this will reduce savings and the current account. China still does have long-standing scope for a fiscal stimulus. But the Chinese economy is only about 6% of world GDP and their effective additional stimulus per year is likely to be around 3% of GDP. 3% of 6% is essentially a rounding error in the world's economy, and will have little noticeable effect globally - although it might just keep oil prices higher than they would be otherwise.

The Chinese current account surplus is likely to decline as exports fall. This represents the partial unwinding of the Chinese-American economic "alliance" of the past decade. As consumers in the U.S. (and elsewhere) finally start saving more, imports from China are falling. China's trade surplus has been protected in the short term by falling commodity prices (which reduce the value of its imports), but in the longer term commodity prices will stop falling before global demand picks up. This will reduce the available funding for the US budget deficit (which will be partially compensated before by increased U.S. saving) and tend to increase interest rates around the world.

Other emerging markets

Pressure on other emerging markets continues to intensify. East-Central Europe (including Turkey), which spent the last several years borrowing heavily from Western European banks, has been especially hard hit by the contraction of credit as those banks turn to hoarding cash. The IMF is projecting contraction for both East-Central Europe and Russia; in the latter case, this is a severe turnaround from estimated growth of 6.2% in 2008.

The European Union's strategy for East-Central Europe is coming apart at the seams. Supporting exchange rates at overvalued levels does not make sense - unless the goal is to protect West European banks, who have lent heavily to the region - and actually adds to adjustment costs. Consequently, social tension is mounting in Latvia and elsewhere. Fresh waves of financial market pressure are likely to move throughout the region, probably triggered by the timing of external debt rollover needs.

In many emerging markets, the foreign exchange exposure of domestic banks are a major problem. Most governments do not have sufficient reserves to fully cover bank debt in foreign currency. To avoid defaults by either the private or the public sector, most emerging markets will need some form of external support, particularly as both commodity and manufactured exports from these countries will continue to fall.

Worldwide, many emerging market countries will need to borrow from the IMF. Some countries will be willing to go early to the IMF, but for most the fear of a potential stigma will lead them to prefer fiscal austerity (and perhaps even contractionary monetary policy) without IMF involvement. The IMF will be more engaged in smaller emerging markets, such as in East-Central Europe. But even if the IMF doubles its loanable resources to $500bn (as recently announced), it doesn't have enough funding to make a difference for large emerging markets, whose problems are due to their own policy mix, particularly allowing the private sector to take on large debts in dollars. We should expect the IMF to lend another $100bn over the next six months (worldwide), and the G20 will keep talking about providing the Fund with more resources.

Larger emerging markets will not suffer collapse, but will increase (attempted) savings and, as a result, will experience slowdowns. The temptation for competitive devaluation will grow over time. But emerging markets cannot grow out of the recession through exports unless there is a strong recovery in the US or the Eurozone or both, which is unlikely. Many emerging markets are particularly hard hit by the fall in commodity prices. While some commodity prices may have reached their floors, a return to the levels of early 2008 will not happen until significant global growth has resumed, which could take years.

Political risks in China, India and other emerging markets create further downside risks. In our baseline, we assume no serious domestic or international disruptions in this regard.

Global Policy Implications

One leading anti-recession idea for the moment is a global fiscal stimulus amounting to 2% of the planet's GDP. The precise math behind this calculation is somewhat fuzzy, but it obviously assumes a big stimulus in the US and also needs to include a pretty big fiscal expansion in Europe. (Emerging markets will barely be able to make a contribution that registers on the global scale.)

This global policy strategy is already running out of steam.

- Very few countries now find room for a fiscal stimulus; debt levels are too high and fiscal capacity is hard pressed by contingent liabilities in the banking system - particularly with an increasing probability of quasi-nationalization. As a result, the idea of a 2% of GDP global fiscal stimulus seems quite far-fetched at this point.
- Further monetary easing is therefore in the cards, especially as fears of deflation take hold, both for developed countries and emerging markets. There may now be some catching up by central banks - in that regard, see the latest Turkish move as a foreshadowing.
- Commodity prices will likely decline further as the global economic situation turns out to be worst than current consensus forecasts. As a result, official growth forecasts for most low income countries seem far too high.
- The worldwide reduction in credit continues, largely driven by lower demand for credit as households and firms try to strengthen their balance sheets by saving rather than spending.

The crisis and associated slowdown started in the US, but the recession is now global. The US economy is no more than 1/4 of the world economy, so even the largest US fiscal stimulus - say 3% of U.S. GDP per annum - cannot be not large enough to significantly raise the world's growth rate at this stage. If we stabilize our financial system fully and restore consumer credit, this will help. But remember that we are subject to shocks from outside and the outlook there is worse than in the US in many ways. Outside the US the tasks look much harder.

One key principle, stated repeatedly by both the G20 and the IMF, is that policy responses need to be coordinated. This is a basic lesson of the Great Depression, when protectionist trade policies reduced exports across the board without benefiting any nation. The current crisis has not seen a widespread outbreak of higher trade barriers - although some of the bailout programs national governments have offered to domestic industries could amount to protectionist subsidies. Instead, however, we are seeing friction over currency valuations, as countries (who can afford to) try to boost their exports. In terms of recent developments, Switzerland threatened to intervene on foreign exchange markets to suppress the value of the Swiss franc. And the French finance minister criticized the U.K. for letting the pound depreciate.

In addition, fiscal constraints give national governments an incentive to reduce the size of their stimulus packages and attempt to free-ride off of other countries instead. Many countries are probably looking to the United States and hoping that our reasonably large stimulus - 6% of GDP, spread roughly over two years - will help turn around the global economy as a whole.

Looking Forward

The first order of business is clearly to revive the US and global economies. However, it is also imperative that we understand the nature of the global economic order that we live in, with the goal of minimizing the chances of a similar economic crisis in the future and reducing the severity of such a crisis should it occur. As mentioned above, while the government balance sheet can absorb the cost of restoring the economy this time, it is not clear how many times we can add 20% of GDP to the national debt.

We also need to recognize that financial crises, just like bubbles, will recur. Government regulators, no matter how motivated and skilled, are no match for the collective ingenuity of billions of human beings doing things that no regulator envisioned. One way to protect a national economy in the face of systemic financial problems is with a sufficiently strong government balance sheet (i.e., low debt relative to the government's ability to raise taxes). This requires counter-cyclical fiscal policy during a boom, which is always politically difficult. However, this implies less room for fiscal stimulus now, or alternatively the need to put in place measures that will compensate for the stimulus once the economy has recovered.

In order to create the conditions for long-term economic health, we need to identify the real structural problem that created the current situation. The underlying problem was that, after the 1980s, the "Great Moderation" of volatility in industrialized countries created the conditions under which finance became larger relative to GDP and credit could grow rapidly in any boom. A credit-fueled boom adds to the political power of the finance industry, particularly large banks. In addition, globalization allowed banks to become big relative to the countries in which they are based (with Iceland as an extreme example). Financial development, while often beneficial, brings risks as well.

The global economic growth of the last several years was in reality a global, debt-financed boom, with self-fulfilling characteristics - i.e., it could have gone on for many years or it could have collapsed earlier. The US housing bubble was inflated by global capital flows, but bubbles can occur in a closed economy. The European financial bubble, including massive lending to Eastern Europe and Latin America, occurred with zero net capital flows (the Eurozone had a current account roughly in balance). China's export-driven manufacturing sector had a bubble of its own, in its case with net capital outflow (a current account surplus).

But these regional bubbles were amplified and connected by a global financial system that allowed capital to flow easily around the world. Ordinarily, by delivering capital to the places where it is most useful, global capital flows promote economic growth, in particular in the developing world. But the global system also allows bubbles to feed on money raised from anywhere in the world, exacerbating systemic risks. Multinational banking strategies also allow financial sectors to become even more important politically across a wide range of countries. When billions of dollars are flowing from the richest countries in the world to Iceland, a country of 320,000 people, chasing high rates of interest, the risks of a downturn are magnified, for the people of Iceland in particular.

Ideally, global economic growth requires a rebalancing away from the financial sector and toward non-financial industries such as manufacturing, retail, and health care (for an expansion of this argument, see this op-ed). Especially in advanced economies such as the US and the UK, the financial sector has accounted for an unsustainable share of corporate profits and profit growth. The only solution is to invest in the basic ingredients of productivity growth - education, infrastructure, research and development, sound regulatory policy, and so on - so that our economy can develop new engines of growth.

But this change in the allocation of resources is greatly complicated by the increased political power of the financial lobby. During the boom years, large banks and their fellow travelers accumulated ever greater political power. This power is now being used to channel government subsidies into the now outmoded (and actually dangerous) financial structure, and in essence to prevent resources from moving out of finance into technology and manufacturing across the industrialized world.

We have done considerable damage to our economies through a debt-fueled bubble. But it could get worse. If the financial sector can use its political power to generate a higher level of subsidies from the government, we will convert even more of our banking industry into pure rent-seeking activities (i.e., all the bankers will do is lobby, successfully, for more support in various forms). If public policy is captured by banks in the US, Europe and elsewhere, then we face much slower productivity and overall growth rates for the next 20 years.

Further coverage of the crisis and policy proposals

Background material
Previous editions of Baseline Scenario:

- November: http://baselinescenario.com/2008/11/10/baseline-scenario-111008/
- December: http://baselinescenario.com/2008/12/15/baseline-scenario-121508/

Financial Crisis for Beginners primer, includes recent material on "bad banks" and the Swedish approach to cleaning up the banking system: http://baselinescenario.com/financial-crisis-for-beginners/

Deeper causes of the crisis, an ongoing series: http://baselinescenario.com/category/causes/

More details on current topics
Strategies for bank recapitalization

- Economic ideas: http://baselinescenario.com/2009/01/27/to-save-the-banks-we-must-stand-up-to-the-bankers/
- Guide to evaluating official announcements: http://baselinescenario.com/2009/02/07/ten-questions-for-secretary-geithner/

Global fiscal stimulus: http://baselinescenario.com/2009/01/21/global-fiscal-stimulus-should-it-be-an-obama-priority/

Citigroup bailout (the second round): http://baselinescenario.com/2008/11/27/international-implications-of-the-citigroup-bailout/ and http://baselinescenario.com/2008/11/24/citigroup-bailout-weak-arbitrary-incomprehensible/

As it happened
First edition of Baseline Scenario (September 29, 2008):
http://baselinescenario.com/2008/09/29/the-baseline-scenario-first-edition/

"The Next World War? It Could Be Financial" (October 11, 2008):
http://baselinescenario.com/2008/10/12/next-up-emerging-markets/

Pressure on emerging markets (October 12, 2008): http://baselinescenario.com/2008/10/12/next-up-emerging-markets/

Pressure on the Eurozone (October 24, 2008): http://baselinescenario.com/2008/10/24/Eurozone-default-risk/

Testimony to Joint Economic Committee (October 30, 2008):
http://baselinescenario.com/2008/10/30/testimony-before-joint-economic-committee-today/

Bank recapitalization options (November 25, 2008):
http://baselinescenario.com/2008/11/25/bank-recapitalization-options-and-recommendation-after-citigroup-bailout/