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IS THIS THE BIG ONE? GLOBAL FINANCIAL TSUNAMI ABOUT TO HIT

Thursday, 03 January 2008

By Larry Elliott of **THE GUARDIAN**

It is 15 years since Britain last suffered a recession. But now the housing market is slumping, oil prices are soaring and a credit crisis is paralysing the banking world. Are the conditions right for a 'perfect economic storm'? Larry Elliott reports

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Gordon Brown says Britain should brace itself for the impact of global financial turbulence. The Financial Times warns that the outlook for the economy is the worst it's been since the dotcom bubble burst at the beginning of the decade. Retailers fear that the Boxing Day stampede to the sales was the last gasp for the consumer before a prolonged period of belt-tightening.

For once, the politicians, the economic forecasters and the business community are in agreement: 2008 is going to be tough. The only question is how tough. Britain has had 15 years without a whiff of recession; instead there has been a decade and a half of uninterrupted growth, with falling unemployment and rising house prices. Even a modest slowdown in the pace of activity, particularly if accompanied by a stagnant housing market, is likely to come as a shock. There are, however, those who think it could be a lot worse than that. The prime minister is certainly worried, noting in his new year message that the "global credit problem that started in America is now the most immediate challenge for every economy".

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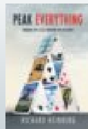

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But it is not just a credit crunch. Oil prices rose to more than $97 a barrel yesterday. The assassination of Benazir Bhutto has destabilised Pakistan and possibly the wider region; climate change has increased the risk of environmental catastrophe. Little wonder that some are saying we should be battening down the hatches in preparation for the "perfect economic storm".

One version goes like this. In October 2008, George Bush finally loses patience with Tehran and, in the last big decision of his presidency, launches air strikes against Iran's nuclear capability. On the same day, just as the citizens of Louisiana, Mississippi and Texas think they have seen the last of one of the stormiest summers on record, a category-five hurricane sweeps across the Gulf of Mexico and shuts down half of America's oil-refining capacity. The combination of military action in the Middle East and natural disaster sends the price of oil shooting up to $150 a barrel, pushing up inflation in all western economies. Central banks, fearful of another 1970s-style surge in the cost of living, raise interest rates, intensifying the effects of the economic downturn. Financial markets suffer a spasm of selling. Banks stop lending and, as businesses fail in their droves, lengthening dole queues prompt a meltdown in the housing market.

No part of the world is left untouched by the turmoil, although the impact is severest on the United States. China does not fall into recession, but finds it is hit by the curse that often afflicts countries that host the Olympics. With the games over, Beijing cuts back on investment and takes action to curb inflation just as exports to the US are being choked off. Growth halves to 5%, with a domino effect through Asia.

This is just one version of the "perfect storm" of 2008, but there are many others. In Britain, there are certainly enough ingredients for a mini-perfect storm all our own. There are contingency plans to nationalise Northern Rock if no private-sector buyer comes along in the coming weeks. Northern Wreck, as it is now called in the City, has already used £25bn of credit from the Bank of England to keep it going since the run on its branches in September - the first major high-street bank to face this embarrassment since Overend & Gurney in 1866.

According to the Halifax, Britain's biggest mortgage lender, the boom in house prices is over. The cost of homes has been falling for three months and analysts warn there may be more to come. The City firm Dresdner Kleinwort points out that Britain has seen four big booms in house prices since the second world war - the late 1940s, the early 70s, the late 80s and the past few years. On all previous occasions, prices dropped by 30% in real terms when the bubble burst.

The accountants Grant Thornton said yesterday that the price of Christmas excess will be a big rise in personal insolvencies. Repossessions are likely to rise in response to a weaker housing market. The government is in no position to take up the slack with higher public spending because the state is already on course to borrow more than £40bn in this financial year. The pound dropped to a record low against the euro yesterday, threatening higher inflation, as the City anticipated fresh cuts in interest rates from the Bank of England to ward off the gloom.

Britain's last two recessions were deep and painful but different in character. In the downturn of the early 80s, it was the country's industrial heartlands that suffered from the loss of manufacturing jobs; a decade later, a year of 15% interest rates meant rising unemployment and record home repossessions. This time, any recession is likely to have its biggest impact on the City - the sector

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most exposed to the credit crunch - and the overblown property market.

But while there are plenty of believers in the perfect storm thesis, the Cassandras are still in the minority. There are forecasters who believe that the US will have a technical recession this year - defined by economists as two consecutive quarters of falling output - but they think it will be a mild affair, nothing like as serious as that of the 80s. What's more, those who remain upbeat can deploy as many arguments to support their view that the global economy will experience a "soft landing" as can the believers in a perfect storm to prove that this is the "big one".

The global economy goes into its current bout of rough weather after its longest period of strong, sustained growth in four decades. China and India are booming, so even if the US is in for a tough couple of years, the big developing countries may compensate. What's more, there is little sign that the acute problems of the financial markets have spilled over into the rest of western economies. There has been no jump in unemployment, and consumer spending has remained strong. As for oil prices, the high cost of crude is the result of strong global demand, not the supply constraints that prompted the global recessions of the mid-1970s and early 80s.

The final argument deployed against the perfect storm thesis is that we have heard it all before. American economist Jeremy Rifkind, for example, said in March 2004: "Here is where events potentially begin to feed off each other, creating the conditions for the perfect storm for the economy. If the price of oil reaches $40 a barrel with an accompanying rise in gasoline prices, the already weak economy could stall."

Oil prices did reach $40 a barrel. They went on to top $90, but far from leading to recession in the US, the world's biggest economy grew by around 3% in both 2005 and 2006 as the housing market boomed. The economy, it is true, slowed to around 2% in 2007 and is likely to slow further in 2008. Even so, says the upbeat camp, talk of recession is unnecessarily alarmist.

That said, there is more to justify the doomsday scenarios than there has been for years. First, it is not just the usual suspects talking about a "perfect storm". The International Monetary Fund said in mid-October that the global economy would barely miss a beat in 2008 - with growth dropping from 5.2% to 4.8% - but barely a month later, its chief economist, Simon Johnson, popped up to warn of a "perfect storm" caused by rising energy costs and the turmoil on the financial markets. "The combination of the credit crunch and high oil prices could bring a big reduction in international trade from which no one would be immune," he said. Merrill Lynch, the US investment house, believes a US recession is already under way, and Alan Greenspan, the former chairman of the Federal Reserve, the US central bank, puts the chances of a global downturn at 50% and rising.

Robert Kuttner, editor in chief of the American Prospect, warned last July that "investors and ordinary citizens have good reason to worry about a perfect economic storm". There was a risk, he added, of a "deepening loss of confidence in the dollar, leading to higher interest rates; higher rates and anxious creditors bringing a crashing end to a hedge fund, private equity and merger binge that depended heavily on cheap borrowed money and that kept the stock market pumped up; the boom in sub-prime bait-and-switch mortgages ending in a morning-after of sinking house values; inflationary pressures in food, oil and other commodities further spiking interest rates - all unsettling financial markets, and

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putting a new squeeze on consumers borrowed to the hilt."

The private equity bubble has burst; America is facing the biggest housing market crash in its history; oil and food prices have risen; the financial markets have been traumatised. The only part Kuttner got wrong was that interest rates have come down as central banks have disregarded the threat of inflation in order to tackle the more pressing risk of recession. Indeed, the repeated, concerted and ever more desperate attempts by policy makers to get the financial markets moving again is the second piece of evidence that suggests the "perfect storm" thesis may be more than just alarmism.

The Bank of England, the Federal Reserve and the European Central Bank have all provided large amounts of "liquidity" - cheap money - in an attempt to persuade the world's banks to stop hoarding their cash and start lending to each other again. Before August, the Bank of England was warning that interest rates might need to go up to head off inflation; last month it cut rates to 5.5%. The Fed cut interest rates three times last autumn; the ECB has put rate increases on hold.

This represents more than just an insurance policy against the possibility of tougher times. Central bankers and finance ministers genuinely believe they are facing a problem that needs to be tackled swiftly. Mervyn King, the governor of the Bank of England, told MPs just before Christmas: "A painful adjustment faces the global banking sector over the next few months as losses are revealed and new capital is raised to repair bank balance sheets."

Finally, there is the fact that the headwinds facing the global economy - a credit crunch, a housing market crash, spiralling oil prices - spell trouble even when taken separately. Together, they are a potentially explosive cocktail.

Ian Harwood, chief economist at Dresdner Kleinwort in the City, said: "Many investors are viewing the near-term economic outlook with apprehension - in our view, rightly so. No end is yet in sight for the US housing recession, and credit market conditions look set to worsen."

One encouraging sign until now has been that there has been no big shake-out in the job market on either side of the Atlantic. If firms were to start laying off workers in large numbers, however, it would, says Harwood, make a tricky situation far worse. "If business responds to falling profits by cutting investment and jobs, you could have both a consumer and business recession. If the banking sector then pulls in its horns, you have a mega-meltdown."

Harwood says the US and Britain may now be about to pay the price for the action taken to avoid recession earlier this decade, when both the Federal Reserve and the Bank of England cut interest rates aggressively in the wake of the dotcom crash. By doing so, they simply replaced the bubble in the stock market at the end of the 1990s with a bubble in the housing market. "We never did have a recession in the early 2000s, because everyone went on to party again."

L Randall Wray, economics professor at the University of Missouri in Kansas City, says the changes in the financial markets in recent decades have made a full-blown crisis more likely. Freed from the shackles imposed on them after the Wall Street Crash of 1929, banks and investment houses have steadily taken riskier bets, convincing themselves that their actions are models of prudence. The

massive losses on the complex financial derivatives based on the US mortgage market have put the activities of the City and Wall Street in the spotlight. If 2008 does see a perfect storm rather than a light shower, the bankers will be called to account.

Wray says that the much vaunted stability of the past decade and more has actually been destabilising since it has encouraged ever greater risk-taking and generated the conditions for a dangerous and unconstrained speculative bubble that inevitably ends in a painful bust. "It is only in retrospect that we can see the boom for what it was - mass delusion propagated in part by policy makers and those with vested interests who should have known better."

Could this, then, be the "big one", the start of a Great Depression to match that of the 1930s? Wray thinks not. "It is likely that the current regulatory system with a 'big government' and 'big bank' will be sufficient to contain the repercussions."

Harwood says the current chairman of the Federal Reserve, Ben Bernanke, is an expert on the Depression and as such "must be very aware of how things can go wrong". Indeed, Bernanke once said the way to prevent a country suffering from deflation - a period of falling prices that can be just as dangerous as runaway inflation - was to drop helicopter-loads of cash from the sky. So far, there are no signs that Bernanke has called for the choppers to be loaded up. But like policy makers everywhere, he probably knows where they are parked.

Every cloud has a silver lining
How to survive a recession

Preparations for a recession are a little like preparations for a freak snowstorm on the M11: hope for the best and make sure you've got plenty of water in your car. You and I can't do much more about the economy than we can about the weather. There are things you can do, however, to position yourself upwind of an economic storm.

1. Live within your means. Most people have a good idea of their income, but little idea of their outgoings. Even when they do try to put together a budget, says consumer champion Martin Lewis, they do it wrong. "They don't put Christmas in and they don't put their summer holiday in," he says. "They multiply by four what they spend a week over a month, when it's actually 4.33. You might not think that's a big deal, but trust me - over a year, that adds up." Lewis's own comprehensive budget, downloadable at **moneysavingexpert.com/budgeting**, should tell you whether you spend more than you earn.

2. Sort out your mortgage. If your fixed-rate term ends in the next nine months, bear in mind that you will need about three months to secure the best new deal. Take advice from an independent broker.

3. Reduce your debt. If you can't pay off your credit cards right away, make sure you're paying as little interest as possible by switching cards. In these uncertain times, Lewis is advising against short-term, zero- interest balance transfers, in favour of deals that offer low interest rates (eg 5.8%) for the life of the outstanding balance.

4. Stop buying stuff. This isn't the time for large, one-off, discretionary purchases. Make modest holiday plans, postpone redecorating and hang on to your clapped-out car for another year. There will be plenty of as-new BMWs going cheap once we hit rock bottom.

5. Spend less on what you buy already. According to Lewis, the average family overspends by £5,000 per year, simply by paying too much for things. This includes the obvious, like insurance and mortgages, but the full list (see **moneysavingexpert.com/moneymakeover**) includes broadband, train fares, gym costs and contact lenses.

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