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The current Polycrisis versus the Global Financial Crisis

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This Policy Brief updates and enriches my Policy Note that was published in May 2020, titled "Can we compare the COVID-19 and 2008 crises?". Since then, we have been living in a "polycrisis" adding economic and geopolitical wars to the pandemic. The update confirms three major similarities between now and the "Global Financial Crisis" (GFC) starting around 2008: persistent uncertainty, analogous economic ups and downs, and growing public debt to GDP. It details more differences: the role of finance hitherto, dissimilar recession shapes and fiscal/monetary supports, fragmentation instead of cooperation, and a resurgence of stagflation. It concludes that "some GFC lessons have been learned". Yet, it adds that "central banks were perceived as key firefighters against crises and may now be criticized by some as pyromaniacs regarding their missions of monetary and financial stability." (See my 2023 Policy Note).

In May 2020, SUERF published my Policy Note #164: "Can we compare the COVID-19 and the 2008 Crises?" (hereafter my 2020 paper). Therein, I called the shock that had just erupted in China the "Global COVID-19 Crisis" (GCC), while "Global Financial Crisis" (GFC) is the generic name of the 2008 crisis that started in the USA. Now, mid-2023, "GCC" could well mean "*Global Crisis Cocktail*", as we are living a "*polycrisis*" going well beyond the pandemic and its aftermath. Indeed, the polycrisis also includes several economic shocks and geopolitical wars, spanning from Ukraine to the US-Chinese tensions.

To assess whether lessons learned from the GFC have been applied in 2020-23, the question remains relevant as to how much history repeats itself or if this time is really different. Toward this aim, this update compares the current polycrisis to the GFC, confirming and enriching some persistent economic similarities but also more and sharper differences. It reveals how much we have learned …or not!

History tends to repeat itself: three major similarities between the Polycrisis and the GFC

#1. Persistent Uncertainty

In economics, uncertainty is often defined as a non-quantifiable risk. Its probability and impact can hardly be predicted, especially in the absence of historical precedent. This applied both to the financial virus (US "subprime" loans hidden in securitized baskets) and the invisible coronavirus that triggered respectively the GFC and the GCC (for more, see my 2020 paper). Given the conjunction of the Russian war at the border of the European Union (and NATO), while US-Chinese tensions are climbing about trade and Taiwan, "uncertainty" currently remains a buzz word.

Chart 1 updates the index of Global Economic Policy Uncertainty, which I had already commented upon three years ago. Here I identify previous economic peaks more clearly. These peaks are higher and higher after the GFC. Those in 2022-23 are admittedly lower than the 2020 climax, but stubbornly very high.

Chart 1: Index of Global Economic Policy Uncertainty (updated until end of June 2023, FRED)

#2. Analogous Economic Plunges and Rebounds

Both the GFC and the GCC started with major collapses in stock exchanges followed by GDP recessions, which were then both partly corrected by rebounds. As regards stock exchanges, after September 15, 2008 (Lehman's failure) and February 19, 2020 (COVID-19 spreading), the S&P 500 twice fell by more than a third. A few months later, it bounced back in both cases, but only by half (cf. my 2020 paper).

Similarly for GDP, major advanced economic areas experienced huge variations in both periods. Table 1 shows large but similar annual changes in real GDP for 2009 and 2020 in the USA, the Euro Area (EA), and Japan. Rebounds were even larger in 2010 and especially in 2021. Annual changes differ from annual growth rates as they correspond to the gap between two consecutive growth rates. For instance, the EA plunge in 2009 equaled -4.9%, the gap between +0.4 and -4.5 (2008 and 2009 growth).

Table 1	GFC Plunge	COVID-19 Plunge	GFC Rebound	COVID-19 Rebound
Annual changes (%)	2009	2020	2010	2021
United States	- 4.6	- 5.1	+ 5.3	+ 8.7
Euro Area	- 4.9	- 5.7	+ 6.7	+11.5
Japan	- 4.5	- 4.3	+ 9.8	+ 6.2

Source: macrotrends.net. Note: as the GFC started in the USA in 2008 and spread to other continents mainly in 2009, the annual changes of 2008 and 2009 are cumulated hereafter for the USA only).

Yet soon afterwards, actual bouts or fears of recession affected several advanced economies, notably in the EA with a double (or triple) dip. This applies in 2011-12, with the EA Sovereign Crisis in the GFC aftermath, and in 2022-23 with the impact of the COVID-19 variants and that of the war in Ukraine.

#3. Similar Changes in Public-Debt-to-GDP Ratios

In 2020, given the lessons learned from 2009, most countries fiscally supported their economies in a huge and even quicker way. This was generally accompanied by extremely accommodative monetary policies. Major central banks resorted to monetary tools such as Quantitative Easing (QE, with central banks buying back to banks the newly issued sovereign bonds).

Massive fiscal deficits spurred public debt-to-GDP ratios, at times of negative or low real and nominal growth. Chart 2a, spanning from 1880 to now, shows the surges in both cases for advanced economies, peaking now at levels above those after the Second World War. For emerging market economies, this was less the case during the GFC, given their limited access to financial markets.

Chart 2: Public Debt/GDP in Advanced and Emerging Economies: long-term vs current (Source: IMF)

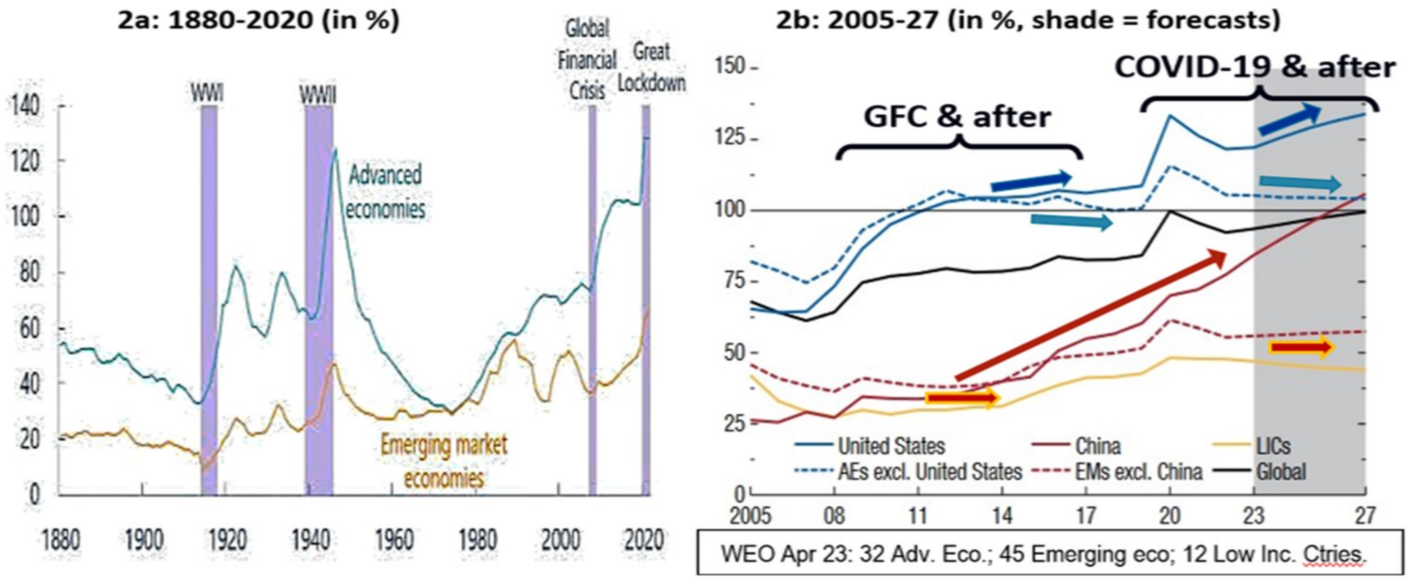


Chart 2b focusses on the recent period and includes IMF forecasts. The US public debt ratio is in solid blue versus that of “Other advanced economies” (“AE excl. US”) in dotted light blue. The ratio for China is in red vs “Other emerging economies” (“EM excl. China”) in dotted red. “Low-Income Countries” (LIC) are in yellow.

After the initial surges in the ratios of public debt over GDP at the core of the crises, there was a plateau, given the nominal recovery boosting the denominator. This was followed by further increases in the USA and even more in China. By contrast, the "AE excl. US" and "EM excl. China" tried to stabilize their ratios. The ratio for LIC with no access to international financial markets exhibits less variations. These aggregated behaviors may of course mask different national patterns depending on the international credibility or idiosyncratic features of each country. For instance, within the EA, national ratios would contrast a cautious Germany with a more pro-active France.

In short, most similarities exhibited so far reflect that, confronted with uncertainty and a series of shocks, public authorities have reacted in similar ways. By drawing some lessons from the GFC, they often tackled the COVID-19 impact on their economies more quickly, subject to their fiscal spaces.

Yet, this time looks different given at least four major economic contrasts

#1. Finance: at fault in '08, at work in '20-22

The first and obvious difference is that inappropriate finance largely contributed to the GFC (hence its name) whereas post-GFC reforms have hitherto helped avoid a global financial contagion.

The ways in which the GFC process contrasts with the GCC is detailed in my 2020 paper. In a nutshell, the GFC was induced by an endogenous financial shock, including the burst of a US housing bubble (houses are both real and financial assets). This first affected the demand side. The shock then spread to the real sector and, via international finance, to the world demand and its supply side. The urgent need was to avoid a "sudden death" of the financial system, first and quickly by supporting failing banks.

By contrast, the COVID-19 shock was triggered by an exogeneous health shock, which affected first the real sector via supply chain disruptions and lockdowns, and then the world demand via transport, tourism, consumption, etc. A lockdown was a self-imposed, voluntary and temporary, "medically-induced coma" of the economy, so as to preserve its human and physical capital. And thanks to the post-GFC financial reforms, there was no financial crisis in 2020-22. Banks continued to finance the economy, sometimes in tandem with the State (cf. the French State-Guaranteed Loans). In a nutshell, finance was part of the 2008 problem and part of the 2020-22 solution.

True, in 2023, the housing sector is affected as well as its funding, particularly its shadow financing in China, but as an effect, not a cause of the polycrisis. Also true, is that three US mid-sized banks failed in early 2023, but without major contagion elsewhere, apart from the well-known and specific case of Credit Suisse. The reasons why post-GFC financial reforms (mainly improving capital and liquidity ratios of banks) were less effective in the USA than elsewhere are summarized in my 2023 Policy Note.

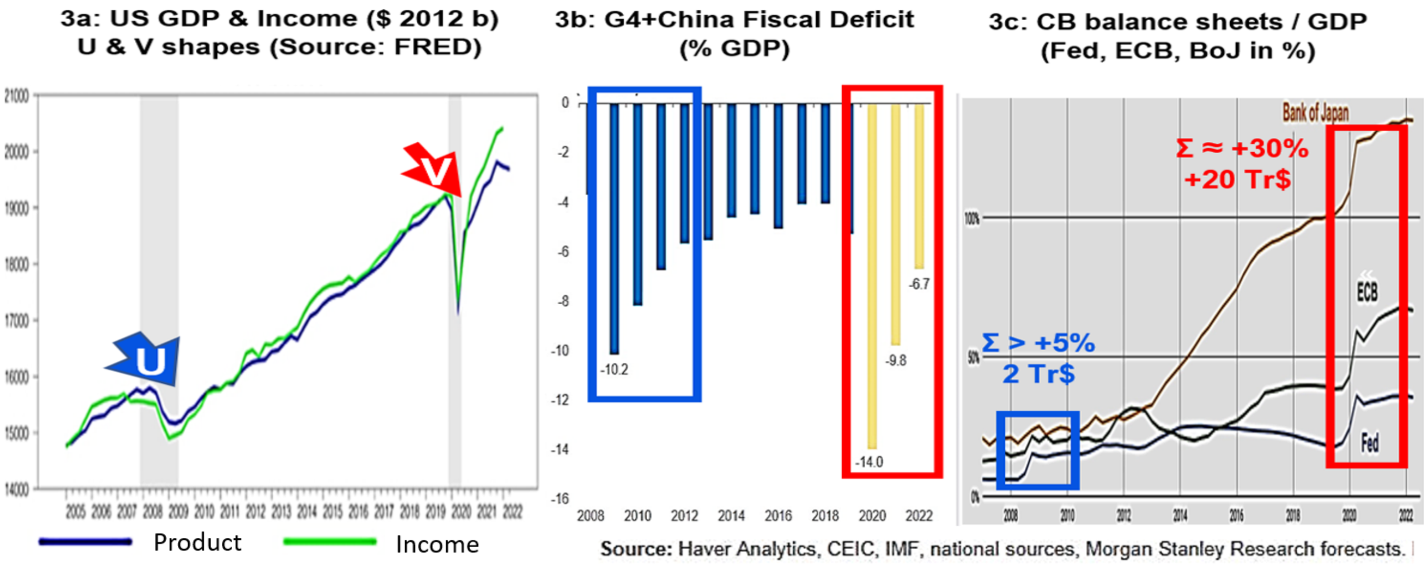
Let's just recall here that mid-sized US banks were exempted from most of the regulatory reforms. In addition, the three US banks which failed in the first semester of 2023 had been poorly supervised despite bad management, notably in terms of liquidity and interest rate risks.

#2. Dissimilar Recession Shapes and Extent of Support

Another major difference between the GFC and the COVID-19 shock concerns the shapes of the economic recessions and the extent to which public authorities could react.

Chart 3a shows in the USA that the shape looked like a "U" during the longer GFC and then a sharp "V" in 2020. The V is even sharper for income (in green) during this electoral year and the Democrat administration afterward. In the EA, given the 2011-12 sovereign crisis and both the variants of the virus and the war in Ukraine, the double dip looked more like a "W". Behind these letters, should not be hidden more casualties and poverty, even if the fiscal boost allowed a quicker recovery in 2020.

Chart 3: Examples of recession shapes, fiscal supports and monetary accommodations



Given higher public debt ratios in 2019 than in 2008, the fiscal space should logically have been slimmer. Yet Chart 3b aggregating China and the G4 (US + EA + Japan + UK) confirms that fiscal deficits over GDP plus China were larger to tackle the COVID-19 shock (in red) than during the GFC (in blue). Although interest rates were often already low, Chart 3c also confirms that monetary policy was more accommodative: see the rise in major central banks' balance sheets, for instance, as QE was revived. Among the reasons why authorities could react more sharply were: the sense of urgency; the lack of precedent (the Spanish flu dating 100 years ago); the GFC lessons and also the absence of an obvious guilt, since it is more popular to subsidize people than banks!

#3. From Globalized Cooperation to Geo-political Fragmentation

At the time of the GFC, globalization had developed for some 20 years, notably with the integration of China's and India's labor and production, helping to lower costs. At the end of 2008, the G20 was elevated to the level of Heads of States and Governments who felt they were all in the same boat and should cooperate. 20 years of globalization explain why cooperation came naturally and lasted during the GFC. As early as 2009, IMF money was increased ($250b in Special Drawing Rights: SDR).

Yet sanctions against Russia after Crimea's annexation (2014) and the trade war between the USA and China (starting in 2017) stalled the process. As COVID-19 affected most countries simultaneously, the similarities in national reactions should not be confused with cooperation and multilateralism. A new increase in SDR was allowed only after the US change in Administration. A larger amount ($650b) helped, for instance, to buy vaccines, although it was almost two years after the start of the pandemic.

In 2022, the Russian invasion of Ukraine triggered stronger financial sanctions. The latter were supported only by the USA and its allies (in blue, Chart 4), whereas the other G20 members (in red) didn't feel concerned or even disregarded them. The same year the G7 GDP, in PPP terms, became lower than the BRICS' one (Brazil, Russia, India, China, South Africa). The BRICS' extension in 2023, accentuates the gap, even if only by a few percent. The G20 has now totally lost momentum … in contrast with NATO.

Meanwhile, Chinese-US tensions regarding trade and Taiwan keep elevating. And even if there was no global financial crisis, international finance has become more of a weapon; examples with payment systems are evoked in my 2023 Policy Note.

Chart 4: 2022 split about sanctions in the G20

#4. Resurgence of Inflation and Stagflation

Last but not least, the contrast in inflation is total after 2020 and after 2009. This mainly results from all the points above, including supply dislocations, excessive support to demand, and fragmentation.

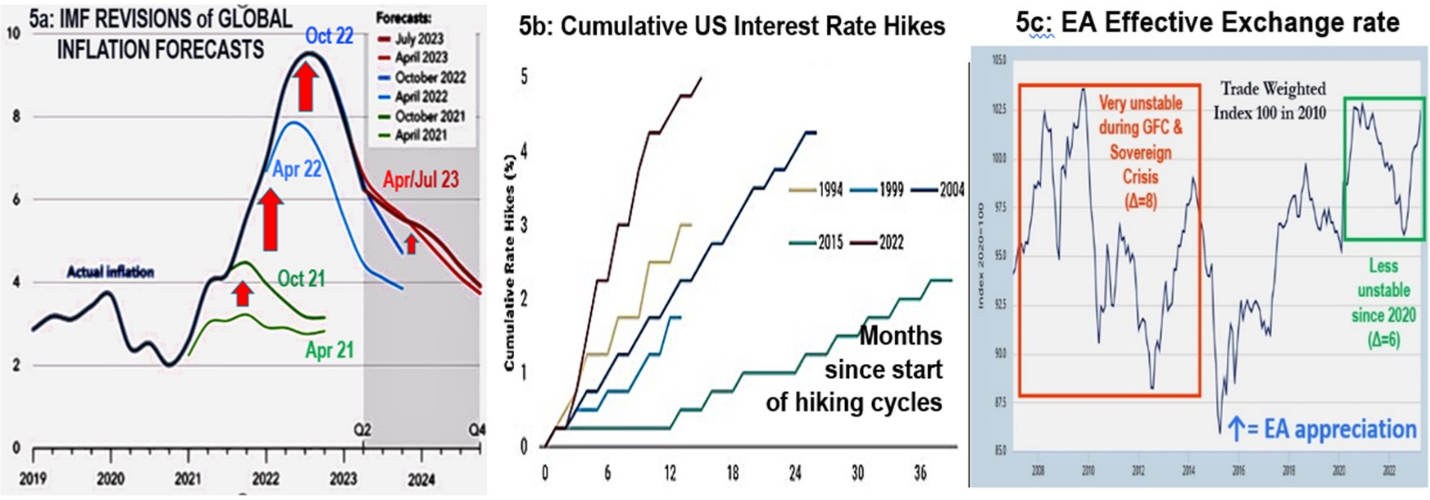
Inflation had stayed low in 2012-20, at the global level, with deflationary risks in the G7 despite active monetary accommodation. True, inflation had rebounded with the 2010 recovery, but, in April 2011, an ECB monetary tightening was ex post judged as premature. Thus, in 2021, the IMF also thought wrongly that inflation was transitory (Chart 5a). Given the unexpected supply shock in Ukraine, inflation became so high and persistent that most central banks reacted (too late with the benefit of insights).

My 2023 Policy Note details the current mix of demand/supply factors, resulting in stagflation (low growth, high inflation). This is the worst-case scenario for central banks, especially if they are facing tight labor markets and, hence, lower productivity gains, higher unit labor costs, and a risk of wage-price loop.

The hiking cycle of interest rates has been the fastest (for instance, in the USA for 40 years; Chart 5b). Major central banks also started to sell back their bonds so as to mop up excess liquidity (Quantitative Tightening). In doing so, they try not to trigger a durable recession nor to destabilize financial markets, including the foreign exchange one. Despite some spillovers, nobody has again castigated, at least hitherto, an "international currency war", as the Brazilian Minister Mantega did in September 2010.

Indeed, given the huge shifts in policies, exchange rates could have gyrated even more. Yet, most economies were affected almost simultaneously by these shocks and the inflation surge. Thus, Chart 5c (updating my 2020 paper) shows, for instance, that the EA effective exchange rate (i.e. against major trading partners) has continued to gyrate less since 2020 than during and after the GFC.

Chart 5: 5a. IMF Forecasts' Revisions; 5b. Fed Hiking Cycles; 5c. Euro Area Effective Exchange Rate



Source: IMF WEO, July 2023 Source: Morgan Stanley Research Source: FRED (+Author's comments)

To sum up, this update confirms my 2020 view: comparing now and the GFC, there are fewer major similarities (uncertainty, analogous economic ups and downs, growing public debt to GDP) than significant differences: role of finance, dissimilar recession shapes and fiscal/monetary supports, fragmentation instead of cooperation, inflation contrast. And the current polycrisis is still unfolding!

Some GFC lessons were learned. Yet, central banks were perceived as key firefighters against crises, and may now be criticized by some as pyromaniacs regarding their missions of monetary and financial stability. Such tough criticism needs to be carefully assessed in my 2023 Policy Note.

About the author

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