



The Recession Virus

'Financial Crisis', 'Credit Crunch', 'Housing Slump' and 'Mortgage Backed Securities'. These are some of the terms we have heard being used almost everyday as the downturn of the global economy plagues countries worldwide. The most recent word added to the line up is 'recession'. A recession is defined as "a significant decline in activity across the economy, lasting longer than a few months". There is also the technical definition of a recession which is "two consecutive quarters of negative economic growth as measured by a country's gross domestic product (GDP)."

As weaker economic data comes out of the United States (US), the prospect that the country will face a long and deep recession is putting the authorities and the recently appointed Obama economic team in the hot seat. How is one to deal with a situation not seen since 2001, after the dot com bubble burst? Undoubtedly, many challenges lie ahead for the US economy, but the ripple effect on the rest of the world is frightening.

The high oil prices seen this year, coupled with high levels of inflation, did not bode well for the oil importing economies of the Eurozone. Adding fuel to the fire was the appreciation of the euro which hurt the export component of the European economy. These factors led to a contraction in GDP in the second and third quarters of 2008, technically marking the first recession for the region since the single currency, the euro, was introduced almost a decade ago.

The Eurozone is comprised of fifteen (15) countries: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, The Netherlands, Portugal, Slovenia and Spain. These countries are member states of the European Union (EU) whose official currency is the euro, which is managed and administered by the European Central Bank (ECB) which has sole authority to set monetary policy.

Since the euro's official launch in January 1999, in eleven (11) of the fifteen (15) EU member states, the pros and cons of a single currency and a single monetary establishment have been realized. The main objective of the ECB is to maintain price stability, thus safeguarding the value of the euro. The adoption of the euro created price transparency, reduced transaction costs i.e. the cost of exchanging currency and lowered exchange rate risks. It has even become a major global reserve currency sharing the status with that of the US Dollar.

The monetary constraint that comes with economic integration has been evident as of late. Some critics argue that a monetary union means "the loss of sovereignty in the field of economic management" especially when it comes to the setting of the bank rate, a rate that would be common to all member states. Not all economies experience boom and bust

cycles at the same time, hence, there is the risk that this rate set by the ECB will affect economies in different ways, some positively and some negatively.

Figure 1

	GDP Growth Q108	GDP Growth Q208	GDP Growth Q308
Eurozone	0.70%	-0.20%	-0.20%
Austria	0.50%	0.30%	0.10%
Belgium	0.40%	0.30%	0.10%
Cyprus	1.10%	0.90%	ND
Finland	0.30%	0.80%	ND
France	0.40%	-0.30%	0.10%
Germany	1.40%	-0.40%	-0.50%
Greece (YoY)	3.60%	3.60%	3.10%
Ireland	-0.30%	-0.50%	ND
Italy	0.50%	-0.40%	-0.50%
Luxembourg	ND	ND	ND
Malta	ND	ND	ND
The Netherlands	0.30%	0.00%	0.00%
Portugal	-0.20%	0.30%	0.00%
Slovenia (YoY)	5.40%	5.50%	ND
Spain	0.30%	0.10%	-0.20%

Source: CMMB Research Centre/Bloomberg

Figure 2

	Bank Rate Q108	Bank Rate Q208	Bank Rate Q308
Eurozone	4.25%	4.00%	4.00%

Source: CMMB Research Centre/Bloomberg

Technically speaking, the Eurozone officially fell into recession in the third quarter of 2008. From Figure 1, one can clearly see the slowdown in growth of the countries within the region. The German economy, Europe's largest, entered its first recession in at least 12 years in the third quarter. Joining Germany and Ireland is Italy, which has slipped into its fourth recession in less than a decade. Spain's economy is reported to have contracted for the first time in fifteen (15) years while growth in the Netherlands stagnated for a second straight quarter.

Germany

Germany is a major exporter of capital and high-end manufacturing goods; hence, the appreciation of the euro coupled with a general slowdown in global demand did not bode well for the country's export sector. As it has officially entered into a recession, it is expected that employers will start to cut back on costs by shedding jobs and possibly slowing growth even further. While the euro has come down from the highs seen earlier in the year, making the country's exports attractive once again, the current state of the world economy, dampened by depressed demand, makes it hard for consumers to take advantage of the competitive prices of German goods.

Ireland

Ireland was one of the first countries in the Eurozone to enter into a recession in light of its heavy reliance on the housing sector and its banks' over exposure to the housing market. As private consumption slowed, so did this small, open economy. With Ireland's now heightened 'exposure to the elements', the economy is subject to the ups and downs of its major trading partners.

Italy

Italy relies heavily on government spending to spur its economy. This factor accounts for one fifth of GDP. As the economy's manufacturing and service sectors contracted, its productivity levels followed suit, thus, slowing domestic demand. Italy is a key concern to analysts as its ability to bounce back from its current state, once external factors improve, is limited. With a debt-to-GDP ratio above 100%, an expansive fiscal policy is not an option for the government.

Spain

Spain's unemployment rate is one of the highest in the Eurozone after Belgium. Like Ireland, Spain's housing bubble burst as domestic demand slowed. With an economy that is heavily reliant on tourism and manufacturing, its vulnerability to the negative external conditions exposes the country to downside risks possibly leading to even more unemployment and weaker growth.

The Netherlands

Like Ireland, the country's openness due to monetary integration exposes the economy to factors beyond its control such as, the euro exchange rate, the price of oil and the strength or weakness of its EU trading partners, France and Germany. Thus, the economy falls prey to some key factors as those experienced by its regional partners including slower consumption and high unemployment, slowing the growth levels of the economy to a standstill.

These economies all share a common theme; they are all run by the same monetary authority, the Frankfurt-based bank, the ECB. This leads us to question the effectiveness of monetary integration. Does it do more harm than good? Are economies left too exposed to external shocks? Are rates set by the bank relevant to all economies which rely on various sectors and go through cyclical stages at different times?

Figure 3

	Inflation Rate Q108	Inflation Rate Q208	Inflation Rate Q308
Eurozone (YoY)	3.50%	4.00%	3.60%

Source: CMMB Research Centre/Bloomberg

One could argue that the ECB started cutting rates too long after the Fed and other central banks as the ECB was focused on bringing down the level of inflation to the target rate of 2%. See Figure 3 for inflation rates. Should this have been the focus instead of growth? Nearly all countries within the zone saw a slowdown in growth yet the ECB maintained the bank rate at 4% for the first two quarters of the year, even raising it by 25 basis points (bps) to 4.25% in July 2008. Not disputing the fact that inflation is a problem that should be addressed, but did it do more harm than good? By July, the Fed had made three cuts to its key interest rate reaching 2% and since then, it has come down even further to 1%. By November,

the serenity of the slowdown in growth in the Eurozone and the possibility of a recession took to the forefront resulting in a surprise cut to the ECB rate to 3.25%. This rate marked a decrease of 100bps in less than a month, all in a bid to boost economic growth.

Studies on monetary integration point out that 'the benefits of a monetary union are more likely to outweigh the potential costs, the greater the degree of real economic integration'. In addition, this calls for political integration which would work in step with a common monetary policy.

As is evident in the Eurozone, the fiscal policy for one country may not be appropriate for another as in the case of Italy, whose debt levels are well above those in the region. This may mean that in a case such as the present, where there is a global slowdown and countries are falling into recession one by one, the recovery rate for each country within the Eurozone will vary. This puts the ECB in a tough position when it comes to the monetary policy for the region as they battle the issue of curbing inflation whilst boosting growth. Furthermore, the recent pull back in oil prices opens the window for further rate cuts as inflation levels are expected to come down.

The road to recovery is expected to be a long one and the challenges faced by central banks across the world to combat the global slowdown will be difficult. The current situation has highlighted and to some extent exacerbated some of the weaknesses in economies around the world. Such is the case with the European Monetary Union (EMU) which has its benefits but there is a need for even more integration to protect the countries within the region from the vagaries of a recession. The Caribbean region can learn a lot from the experiences and challenges being faced by the EMU when it comes to the implementation of our Caribbean Single Market and Economy (CSME).

FINANCIAL & ECONOMIC INDICATORS

As at 27 November, 2008

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	95.19	93.69
Euro	1.29	1.25
Jamaica	77.25	77.05
Guyana	204.20	204.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	53.71	49.62
Natural Gas (US\$/mmbtu)	6.45	6.75
Gold (US\$/Troy Ounce)	815.83	745.06

Eurobond Indices (As at 27-November-08)

Lehman Brothers Global Aggregate Index (Return % YTD)	-0.97
JP Morgan EMBI+ (Basis points)	705
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	-22.52

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	1.00	1.00
Euro Zone	3.25	3.25
Japan	0.30	0.30
Brazil	13.75	13.75
Trinidad	8.75	8.75
Jamaica	13.50	13.50
Barbados	4.00	4.00

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.05	0.04
US 10-Yr Treasury	2.98	3.02
3-month UK Libor	3.93	4.07
Japan 90-day T-Bill	0.48	0.48
Brazil 90-day T-Bill	14.37	13.70
TT 90-day T-Bill	7.04	7.09
Jamaica 90-day T-Bill	16.92	15.21
Barbados 90-day T-Bill	4.07	2.94

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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