

**Deeper crisis & shock therapy
On the way to a new world**

**Scandinavian-Polish
CHAMBER OF COMMERCE**

April 6, 2009

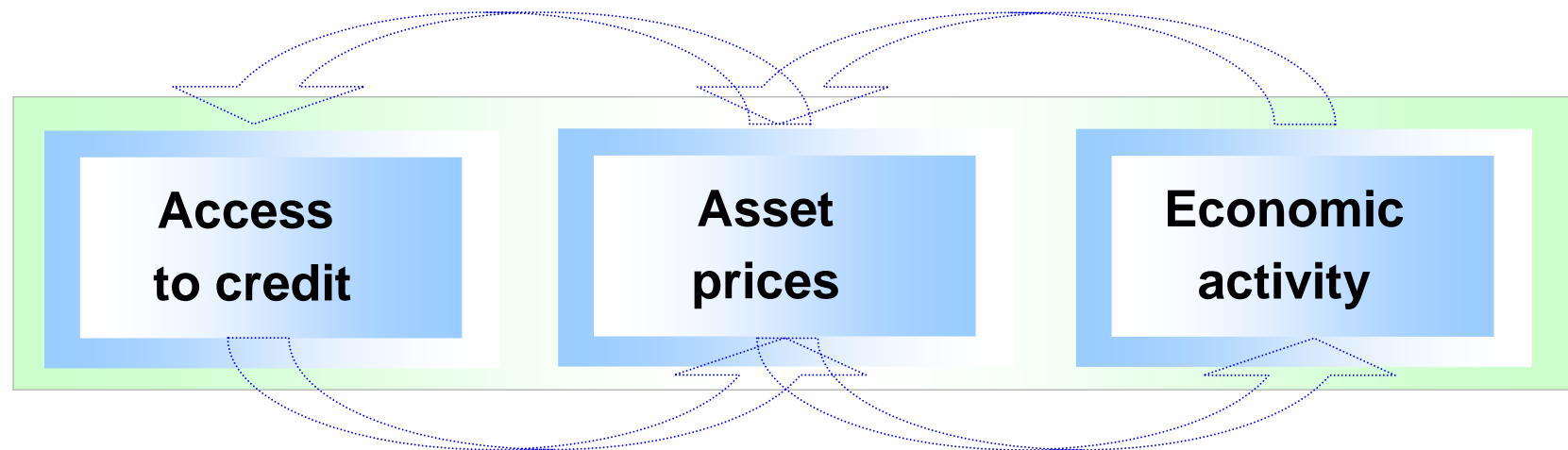
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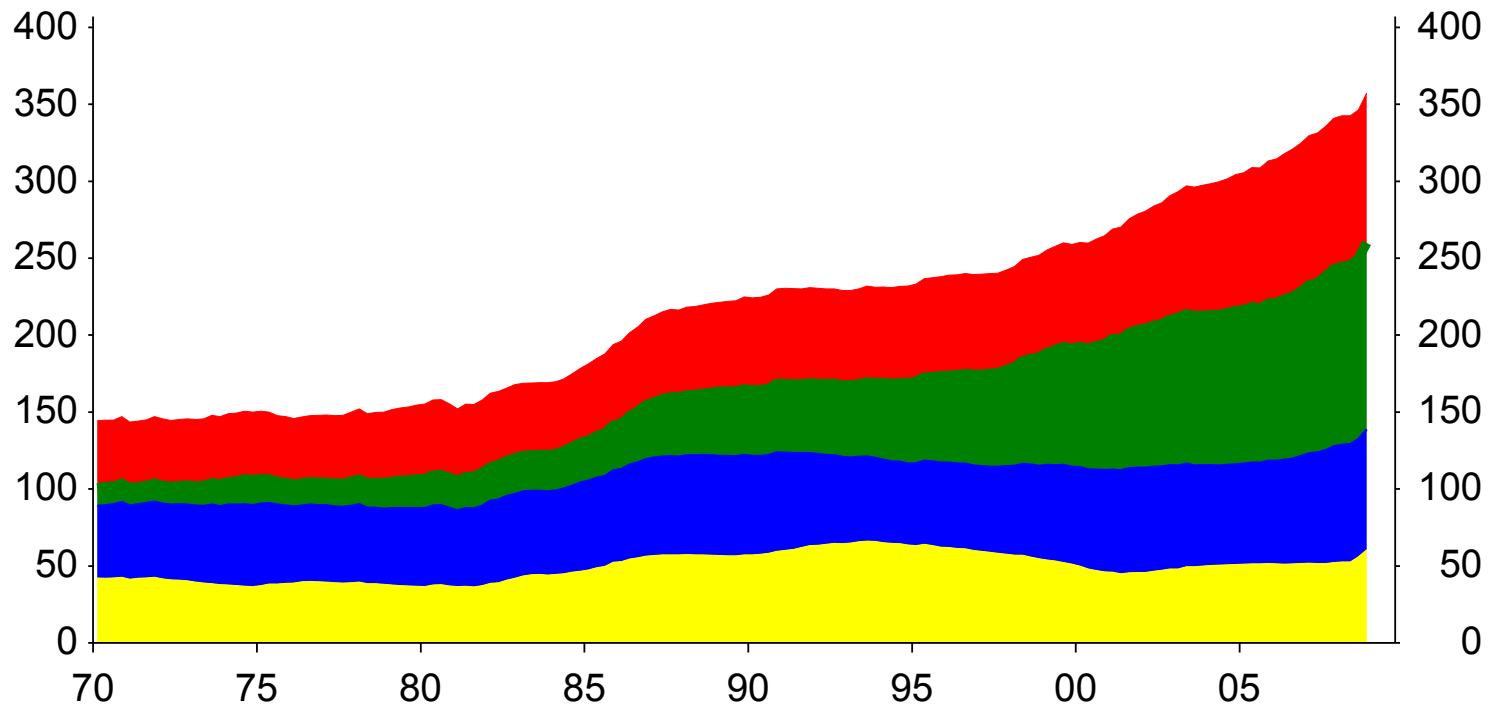
Interaction: Credit cycle, asset price cycle and business cycle



US: Long-term debt build-up

US: Liabilities

Per cent of GDP



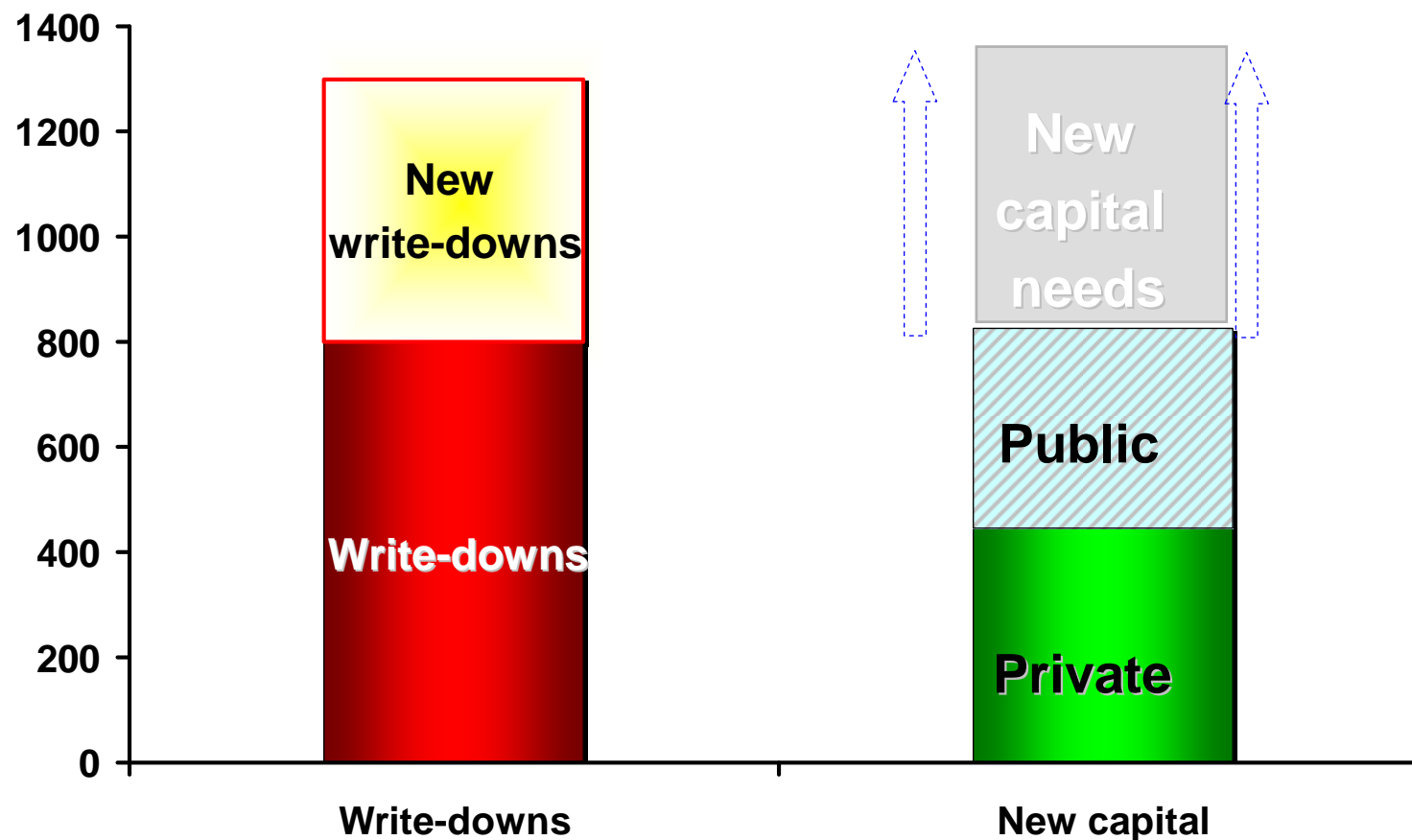
- Households
- Business
- Domestic financial sector
- Public sector

Source: Federal Reserve



Write-downs and capital infusions

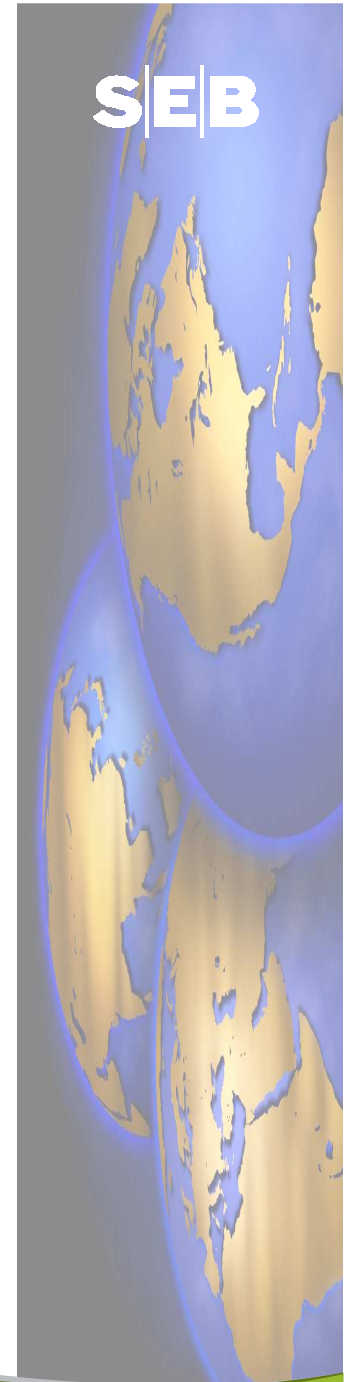
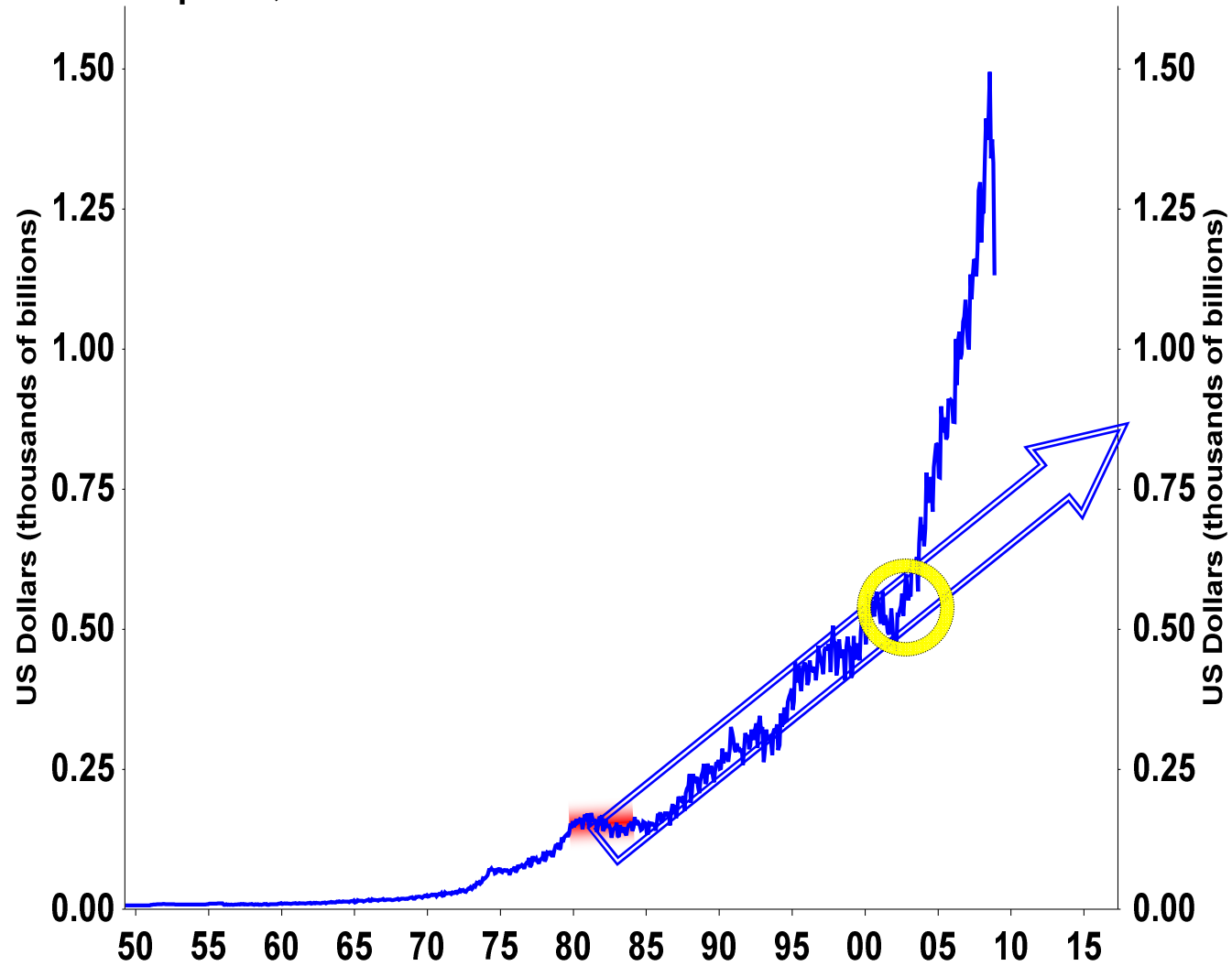
Global banks. End of January 2009. Trillions of US dollars



Källa: IMF,
Januari 2009

The power of globalisation!

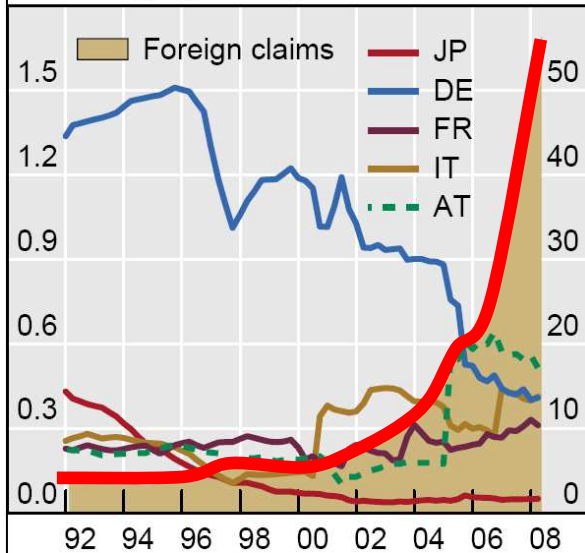
World export, trillions of US dollars



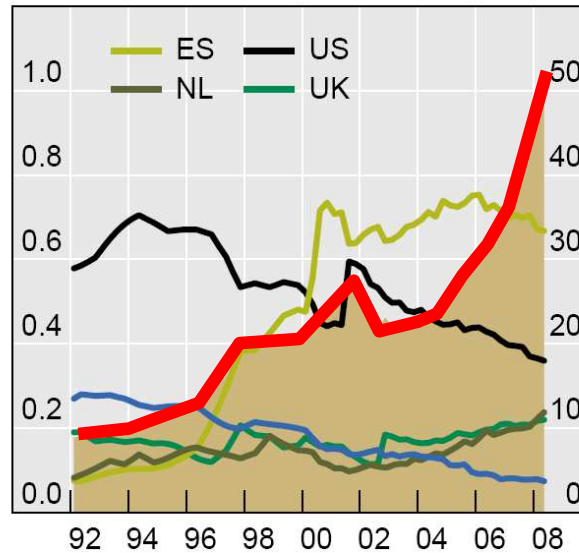
Bank exposure to emerging economies **S|E|B**

Key creditors to emerging markets¹

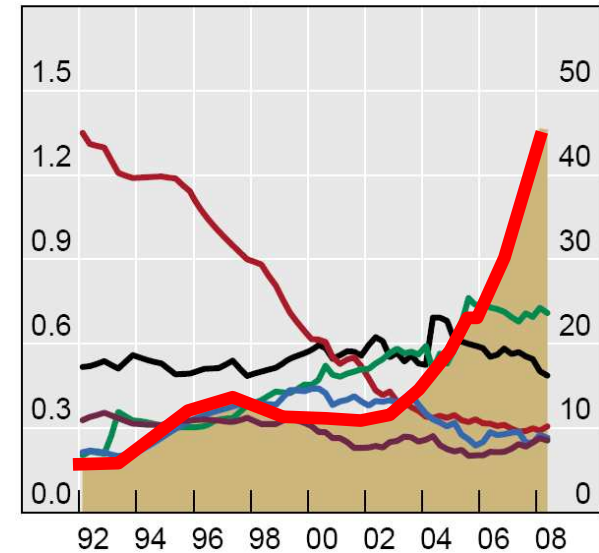
Emerging Europe



Latin America



Asia-Pacific



Our picture of a world in acute crisis

Navigating uncharted territories without a map and a compass

Globalisation “hangover”

Crushed illusions: The super-cycle, decoupling, international dependence, financial risk, price/availability of money

Large adjustment needs in

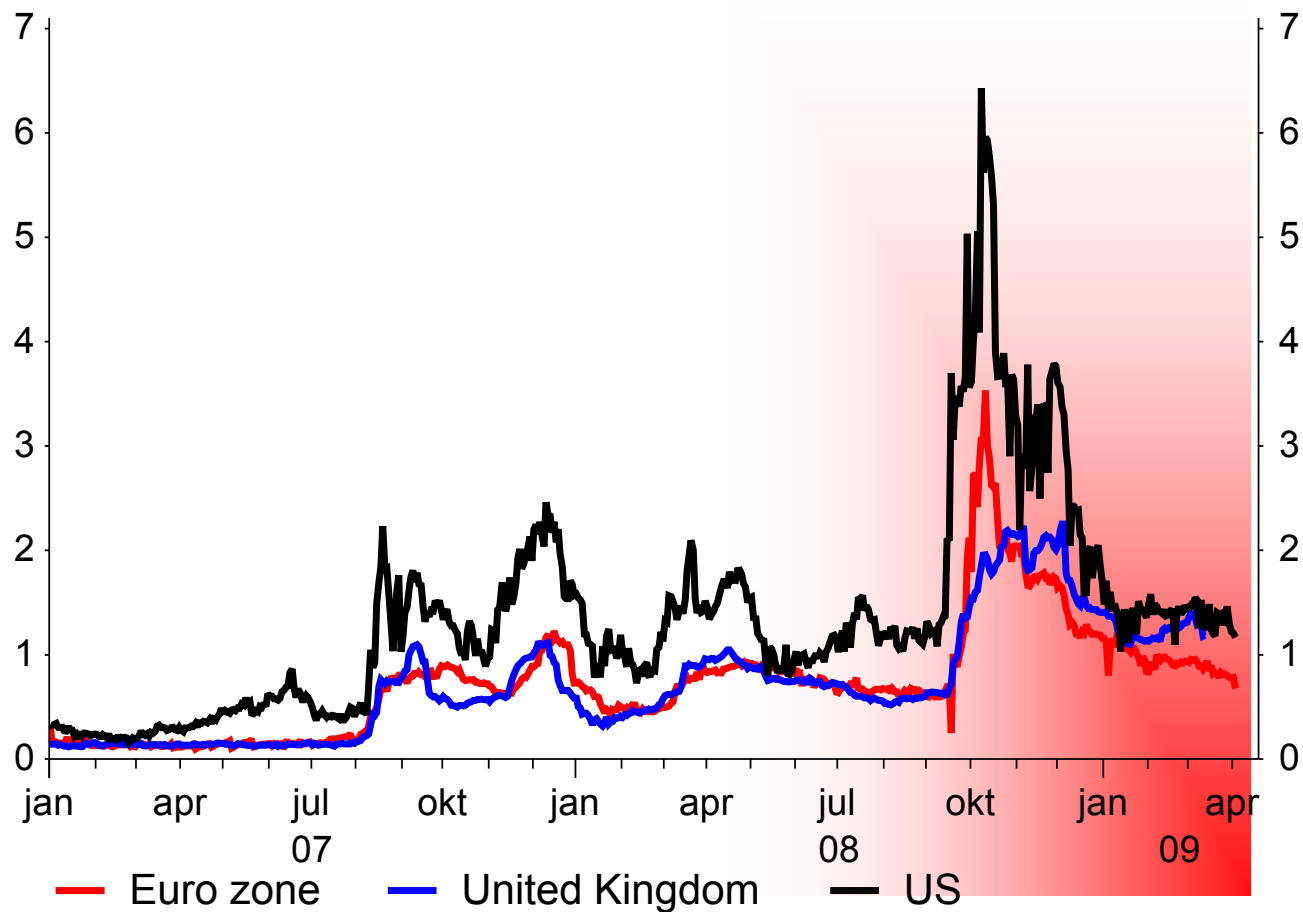
- The global credit market
- Business models and scale of operations at financial and non-financial companies
- Development plans of emerging economies



Normalization in the interbank market

Interbank rate minus Treasury bill rate (3m)

3 months



Source: Reuters EcoWin

S|E|B



Squeezed from two directions

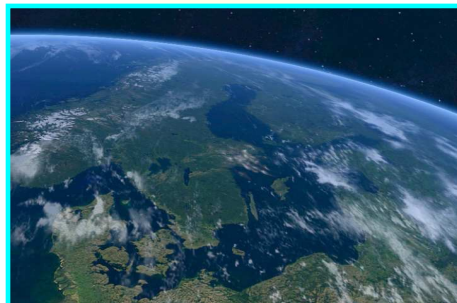
Combined “credit crunch” and “crowding out”

**Global
credit market
is shrinking**

Households
Banks
Companies
Municipalities
Governments

**Governments
raising capital
for aid packages**

Further
rescue
operations



Central
banks
buy gov't
bonds



Which crises can we learn from?

■ 1930s and Japan

- Deflationary threat scenarios after financial bubbles

■ 1970s

- Stagflation after American over-extension, systemic collapse for exchange rates plus oil price shocks

■ 1980s

- Recession as the price of a new system based on low-inflation policies

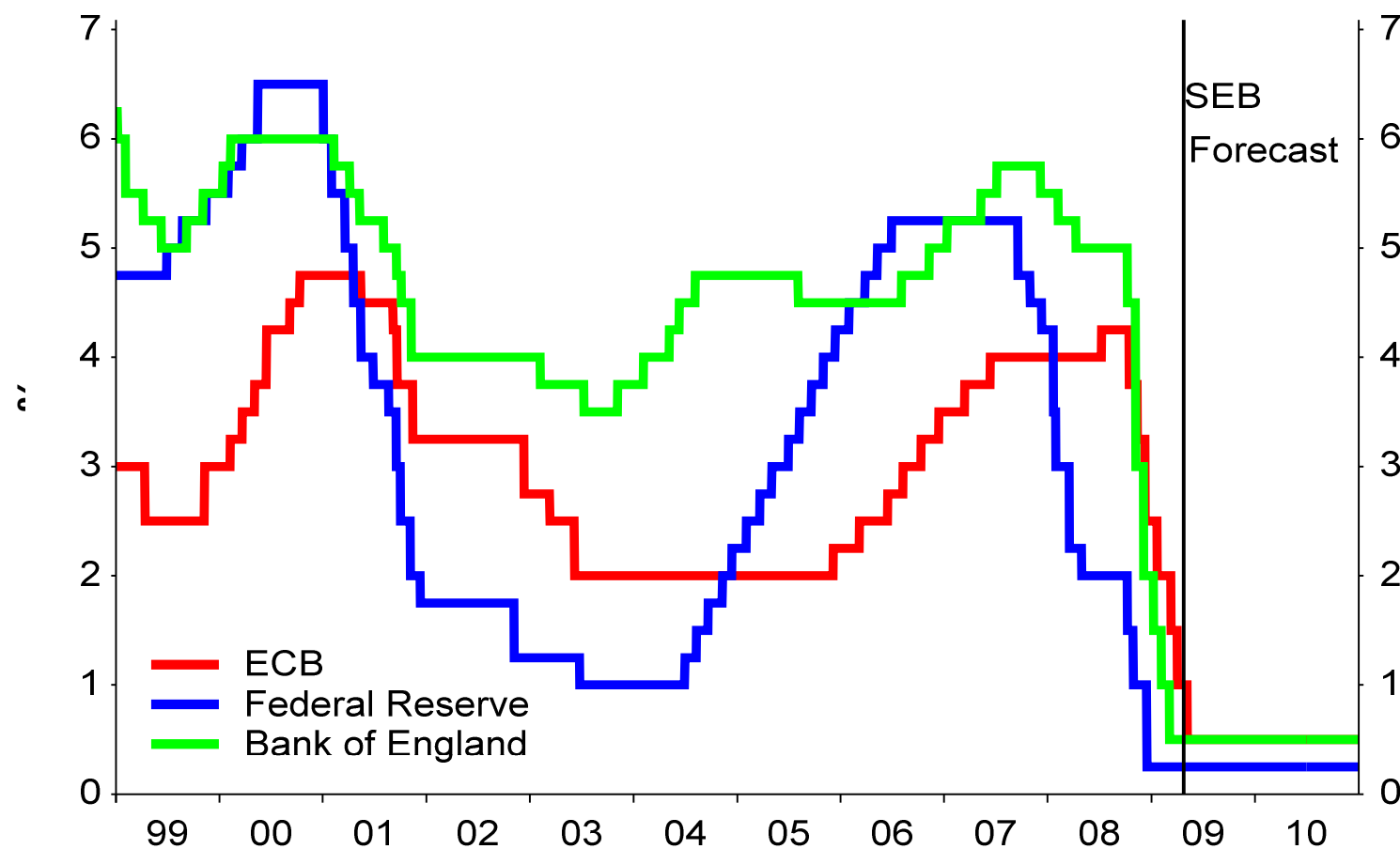
■ 1990s and post-millennium shift

- Property and stock market bubble without lasting impact

Conclusion: Today's threat scenario most resembles the 1930s and Japan, but this time the policy response was mobilised much faster



Approaching zero rate policy



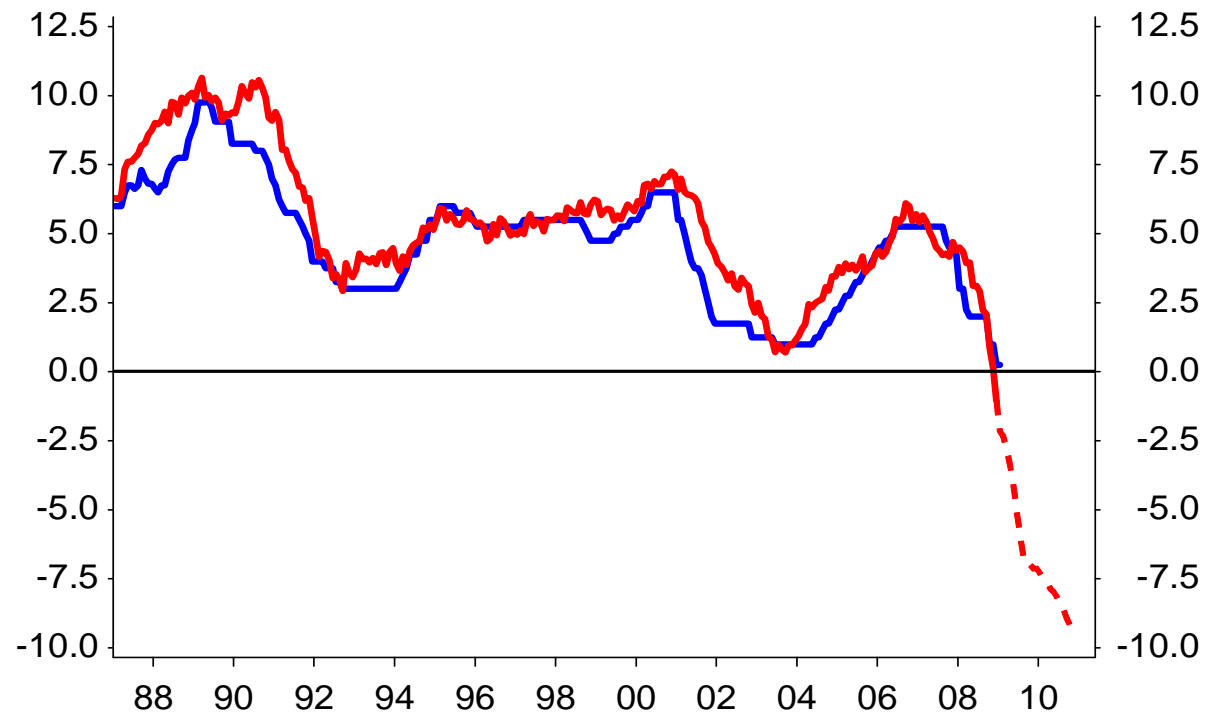
Sources: ECB, Fed, BoE, SEB



US: Zero Fed funds rate is not enough

The zero bound bites

Per cent



Source:
Goldman Sachs

— Fed Funds Rate - - - Taylor rule

Next act of the inflation drama

- **Commodity price effect will culminate in 2009**
- **Record-sized output gaps will squeeze pay**
- **Will wage and salary cuts save jobs or make the deflation spiral permanent?**
- **Purpose of today's crisis policies is, in practice *"to play with inflation fire"***
- **How do the warning stages of inflation work?**
 - 1) Transmission begins to work
 - 2) Demand takes off
 - 3) Output gaps close
- **Inflation risks appear only after that**



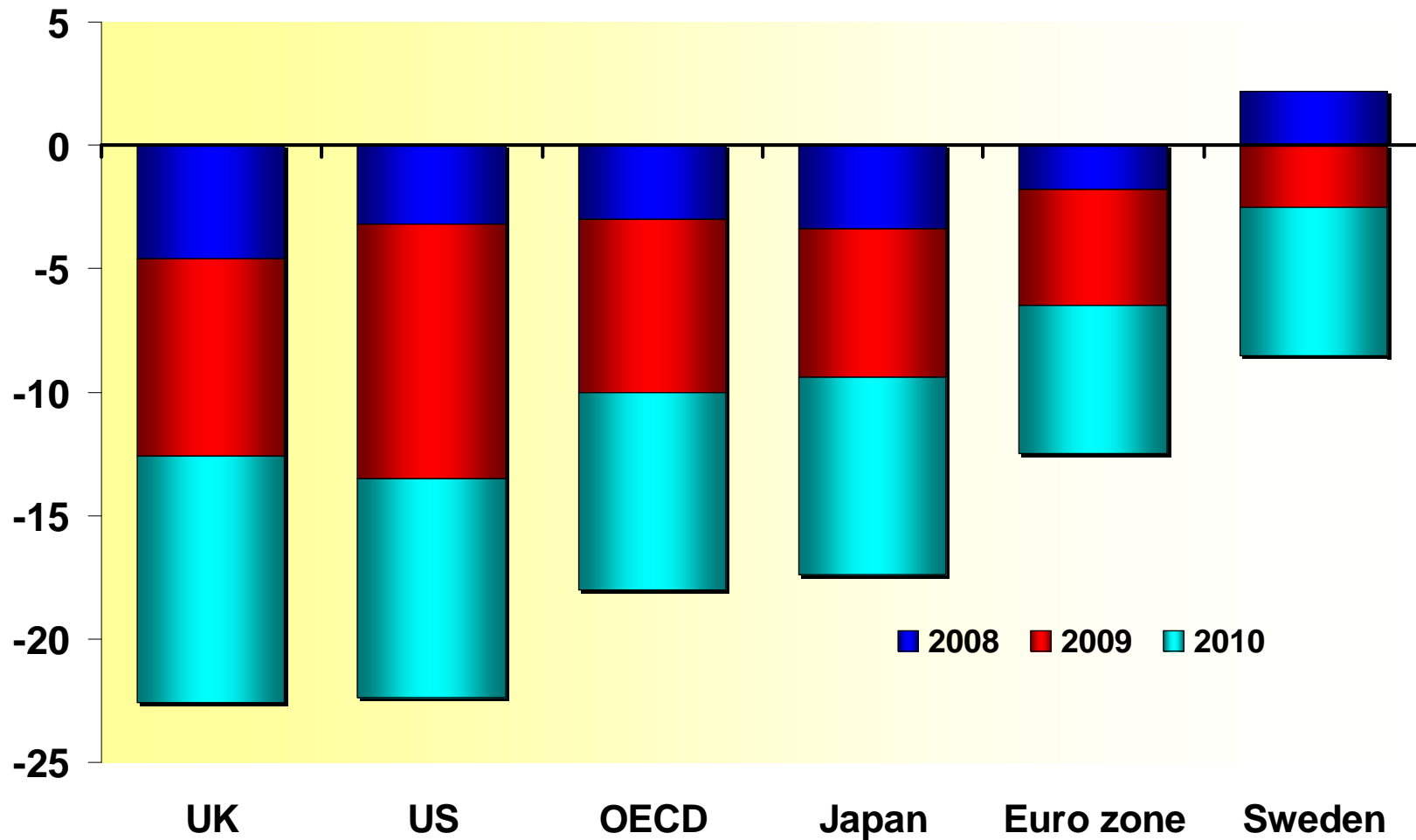
The renaissance of Keynesian fiscal policy

- **Monetary policy overworked**
- **Fiscal policy effective in times of crisis**
But there are drawbacks
 - **Increasing government debt means future burdens**
 - **Ricardian equivalence may reduce impact**
 - **Crowding out via interest rates in long term**




Rapidly growing budget deficits

Total budget balance, 2008-2010, per cent of GDP

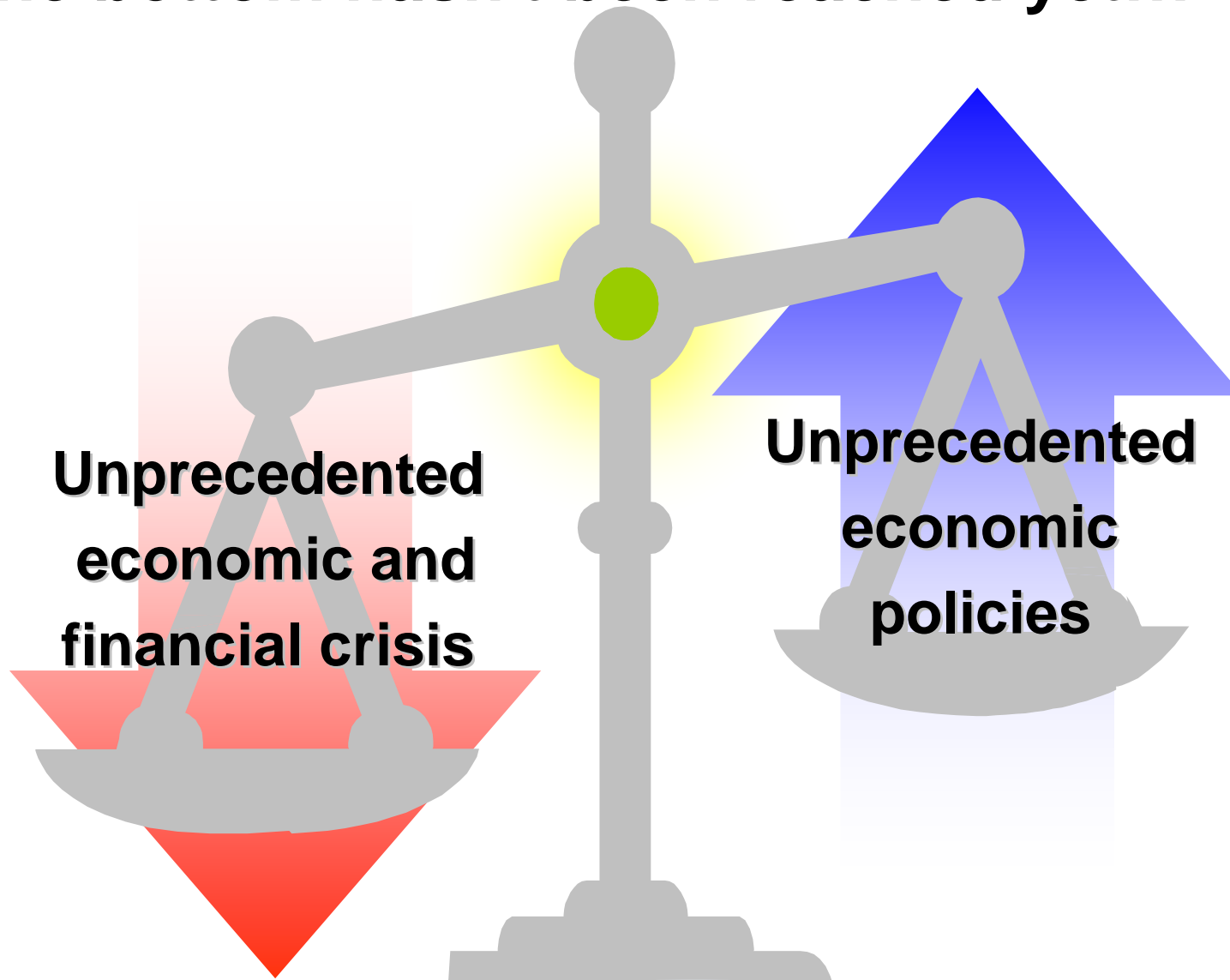


G20 London Summit: Official statements

- **Restore confidence growth and jobs**
 - **Repair the financial system to restore lending**
 - **Strengthen financial regulation to rebuild trust**
 - **Fund and reform our financial institutions**
 - **Promote global trade and reject protectionism**
 - **Build an inclusive, green and sustainable recovery**
- 

The bottom hasn't been reached yet...

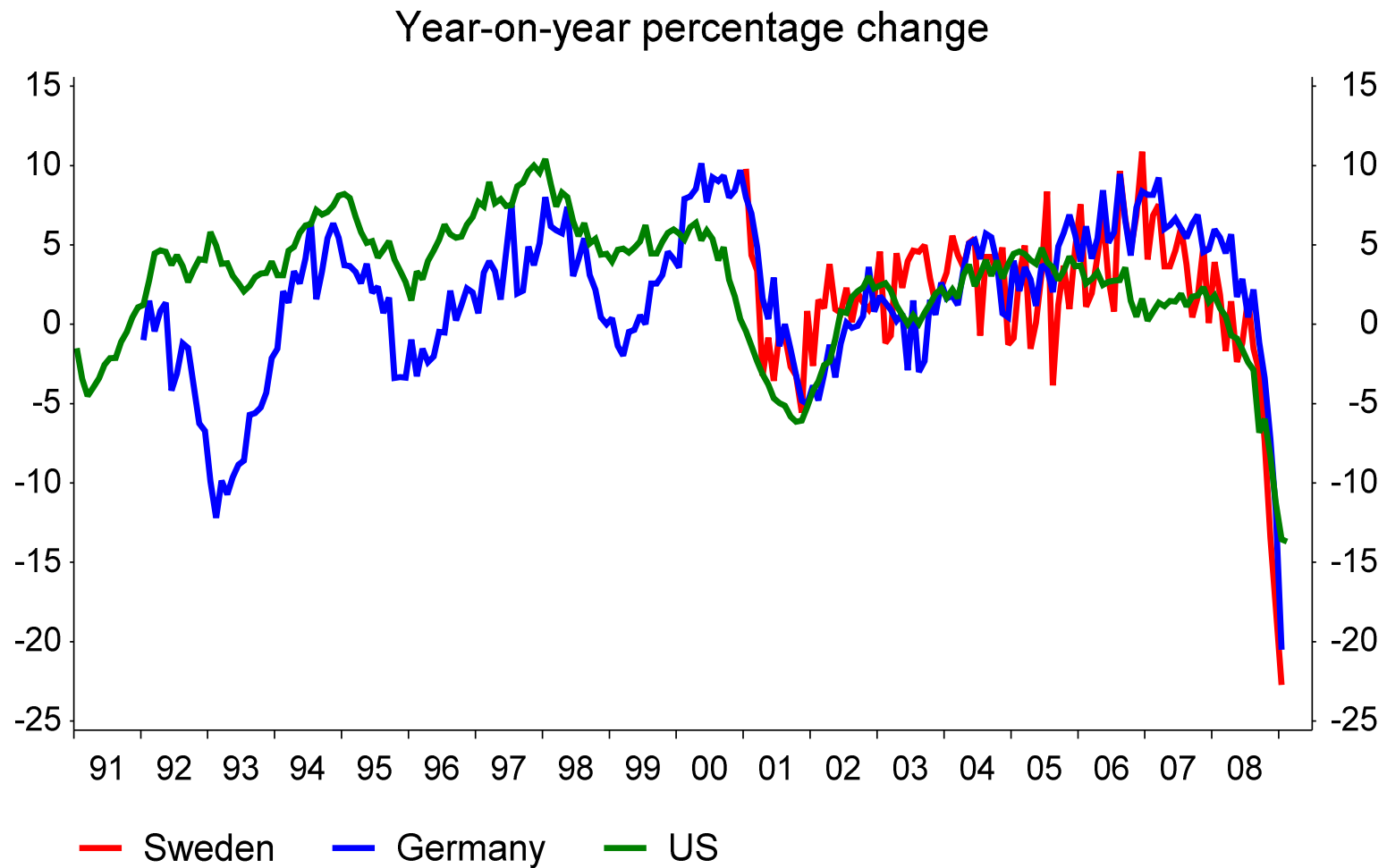
S|E|B



**Unprecedented
economic and
financial crisis**

**Unprecedented
economic
policies**

Synchronised decline in output

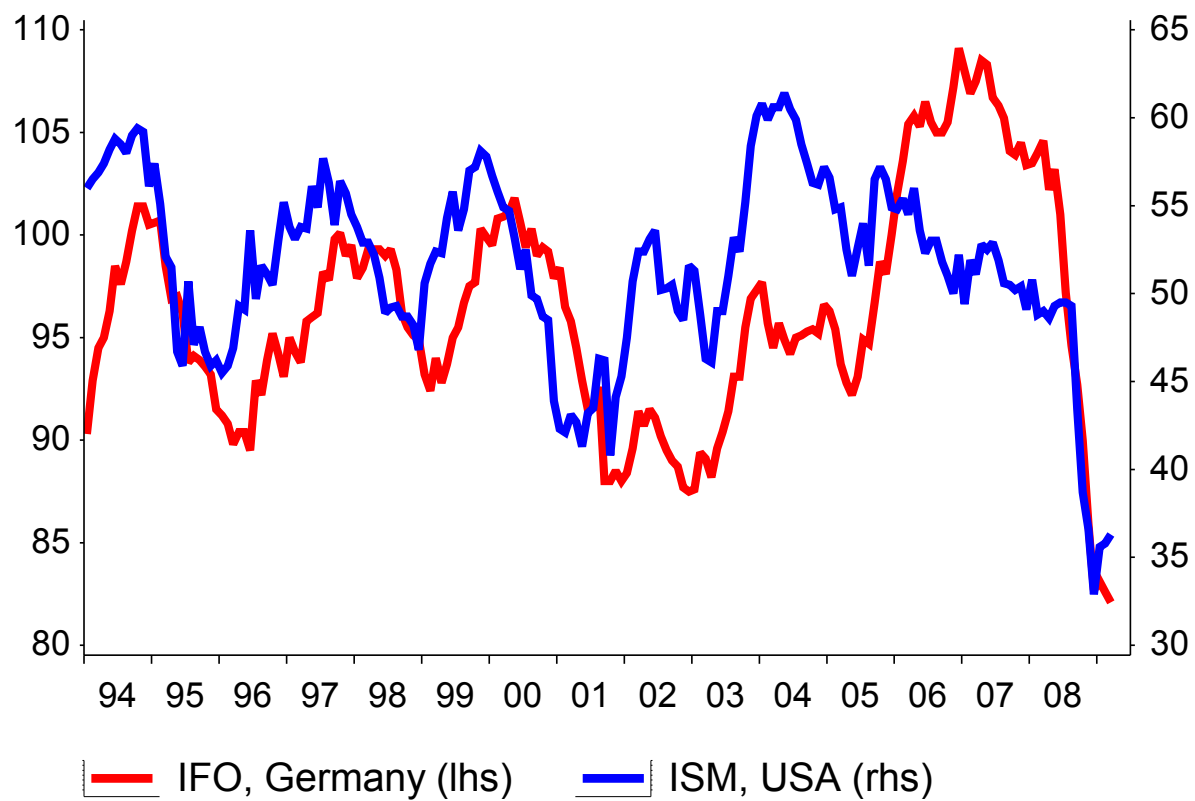


Source: Reuters EcoWin

Stabilization under way?

IFO and ISM

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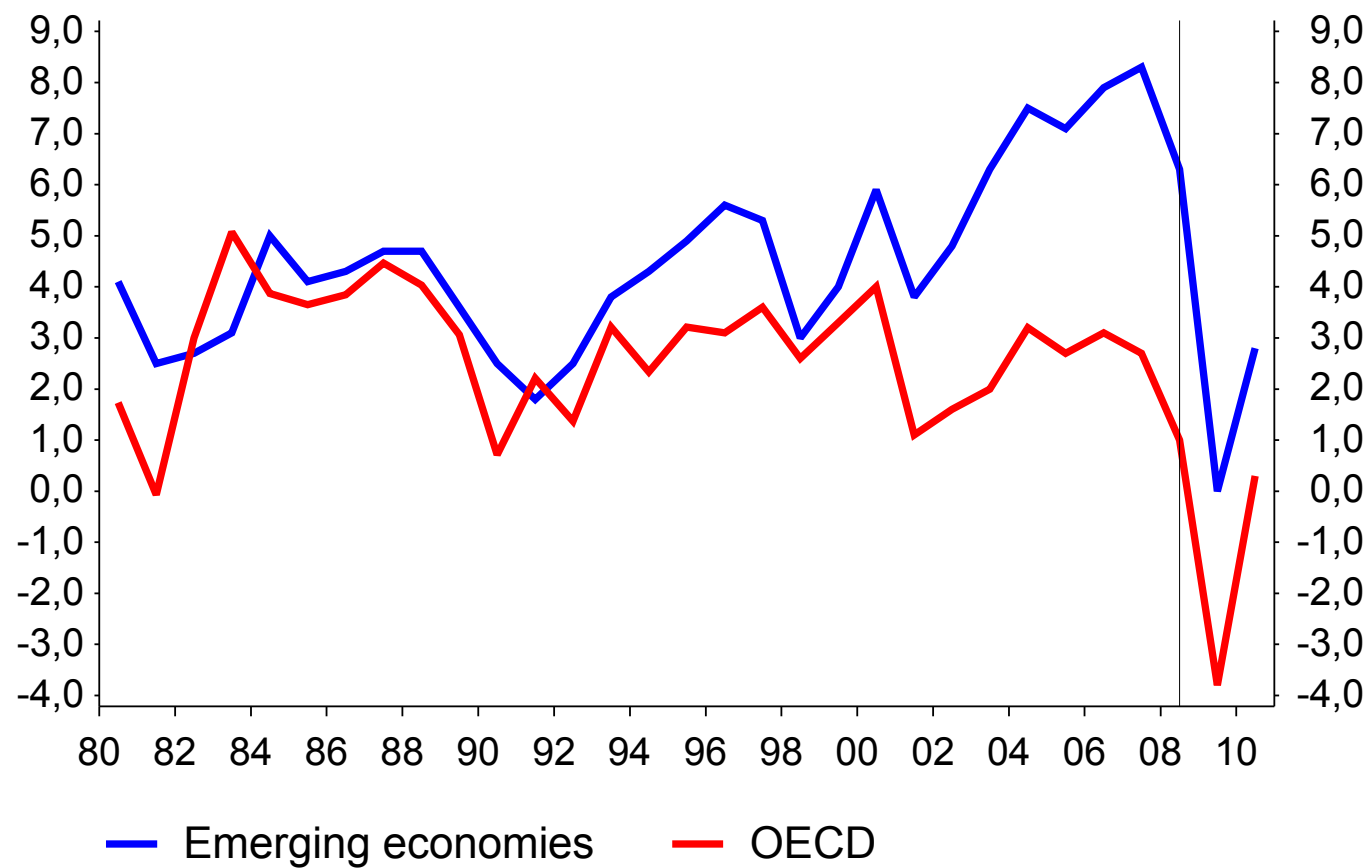
Källor: IFO, ISM



A delayed recovery

GDP

Year-on-year percentage change




Gloomier global outlook

GDP: Year-on-year percentage change

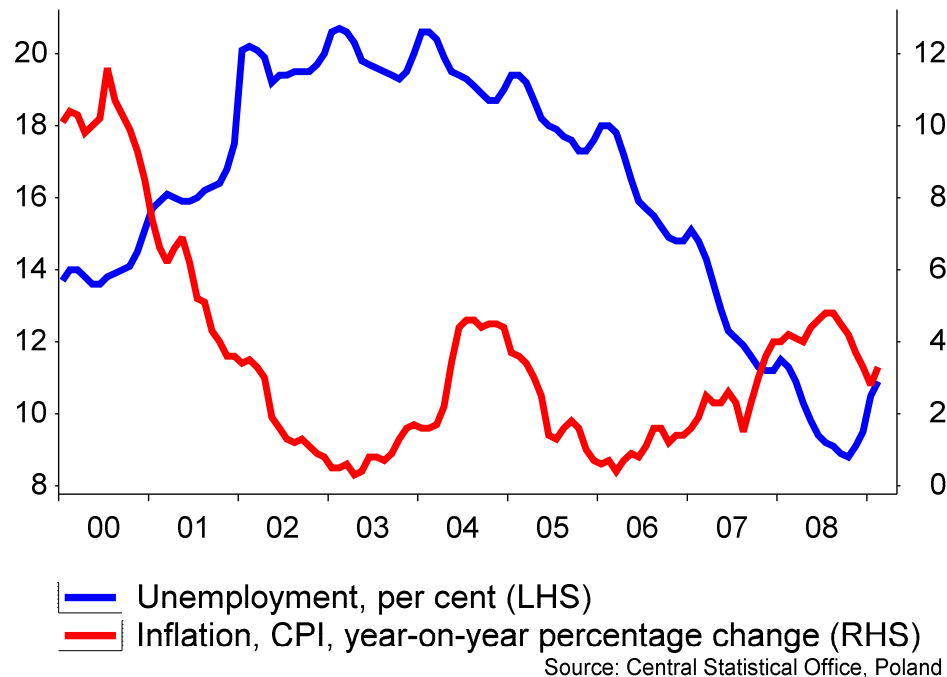
	2007	2008	2009	2010
United States	2.0	1.1	-3.4	0.7
Euro zone	2.7	0.7	-3.6	0.0
Eastern Europe	7.4	4.5	-5.2	0.6
Poland	6.7	4.8	-2.5	1.0
The world (PPP)	5.0	3.2	-1.5	1.4
Oil, USD/barrel	72.9	97.2	40.0	45.0
EUR/USD, Dec.	1.46	1.40	1.20	1.40

Central and Eastern Europe: Three “risk categories”

- ***Worst affected. The Baltics, Ukraine***, Hungary and the Balkans. Characteristics: Large external imbalances. Large financing needs after explosive credit growth in some cases. Relatively high share of total borrowing denominated in foreign currencies
 - ***Prudent Central Europe. Poland***, Slovakia and the Czech Republic, with decent fundamentals. Moderate external imbalances. Rapid build-up of private indebtedness but with a modest share of total borrowing denominated in foreign currencies
 - ***Russia***. Strong initial fundamentals: twin surpluses. Rapid build-up of private indebtedness but with a modest share of total borrowing in foreign currencies
- 

Poland: Cannot escape recession

Poland: Inflation and unemployment

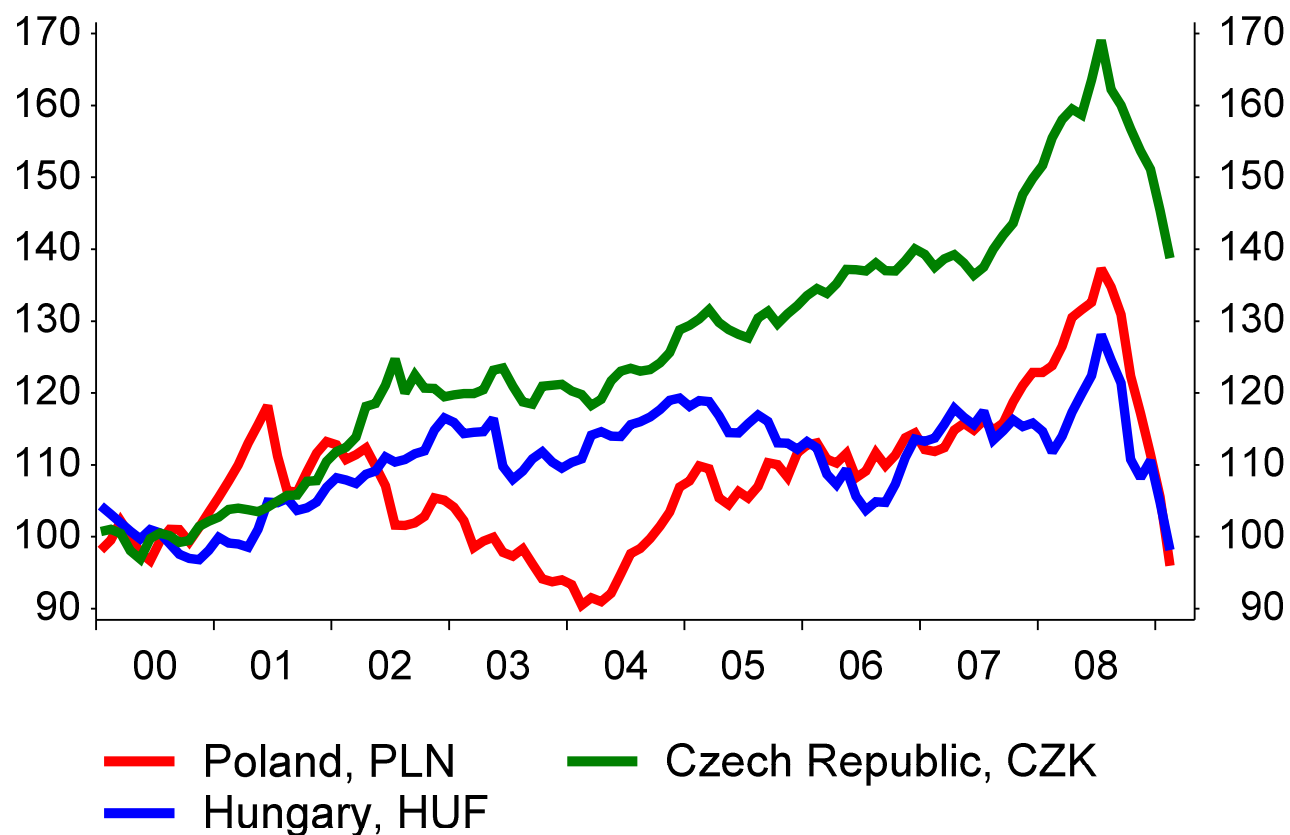


- GDP down 2.5% this year – slight recovery in 2010
- Moderate imbalances and a more closed economy
- Consumption will provide some support, despite rising unemployment
- Inflation will fall to within the central bank's target range
- Further rate cuts to 2.50%
- Short-term foreign debt a source of concern – zloty will slide once again
- ERM2 and euro zone accession will be postponed

A shock wave has hit many currencies in Central and Eastern Europe

Trade-weighted exchange rates

52 countries, index 100 = 2000, until February 2009



Source: BIS

Estonia first in euro timetable

	Official	Our view
Estonia	2010	2012
Latvia	No target	2012
Lithuania	2011-2012	2013
Poland	2012	2013
Czech Republic	No target	2013 at the earliest
Hungary	No target	2014

Summary

- **Crisis policies must deal with the effects of...**
 - Continued global structural reduction in debts
 - De-globalisation, deceleration and downsizing
-
- **Deep, synchronised recession 2009/2010**
 - **Wage and salary squeeze/resource gap = deflation risk > inflation risk**
 - **Low interest rate environment, printing of money, huge government budget deficits**
 - **Europe's challenges rapidly growing**

