

# International Economics Research Paper: Is the next Global Depression imminent?

Author: Savr Kumar  
Graduating from Mallya Aditi International School  
Address: 13th main, 3rd block, Koramangala, Bangalore - 560034

## Abstract:

The paper delves into globally contrasting perspectives on whether the next financial crisis is imminent and from where it may originate, as well as in what fashion and what the implications are. There are varying perspectives on the American, Chinese and Indian economies for instance, which are some of the biggest economies in the world and thus the most pertinent to the topic.

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It is widely contested whether the next global depression is imminent in the next few years or whether the current period of expansion being experienced by countries such as the US will last well into the foreseeable future. The current expansion will be the longest in the history of the US, it continues until the middle of 2019.

According to Ryan Avent, a senior editor at the Economist, this time the economic vulnerabilities aren't quite as large as during the 2008 crisis. They are large enough that we could see a slow down in GDP growth and a slowdown in trade – things of that nature. The real risk is our lack of preparedness and the lack of room of global cooperation. This may start as a minor downturn but may turn into something much larger and much more difficult to deal within the next year or two.<sup>1</sup>

According to him there are numerous obstacles at both the national and multilateral level. Within countries, governments are much more polarized while across the world there are lots of populist and nationalist parties. This will make it harder to reach the

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1 <https://www.youtube.com/watch?v=rD7KNVzkLPw> - How to prepare for the next global recession | The Economist

much needed agreement to launch big spending programmes or other legislation of that nature.

Then there's also agreement between countries which makes it much more likely that there will be contentious policies, tariffs may go up and there may be currency and trade wars.

According to him, this recession is not inevitable and attempts can be made to avoid it. There are certain drawbacks, however, and reasons why these attempts may not work.

Australian Vantage Point asset Manager Nick Ferres suggests that he identified that there was a genuine risk that the banking system would be insolvent in the US before the 2008 crisis. He says its possible it could all happen again, even in a matter of months, because of the debt of US corporations rising and the unregulated non bank sector. No one can ignore the fact that debt has more than doubled as a percentage of GDP in China, over the last few years. <sup>2</sup>

The tools governments usually use to fight a recession won't be available next time around in the same way that they normally are. Interest rates will be low. We usually rely on central banks to do interest rate cutting to stimulate spending and growth but they might not be able to do that. Pretty quickly they are going to have to turn to less tested methods. Money printing to buy bonds – quantitative easing – which is what was used last time. Quantitative easing is much more uncertain way. It is more politically contentious than some of the tools that are used ordnarily.

Nonetheless, governments should be modifying their central bank targets, preparing their budgets (to include measures that increase spending automatically when the economy weakens in the future so that they don't have fights in parliament about whether to expand spending when the time comes), and most importantly, coordinating their actions with each other. That makes it much more likely that we do not witness a repeat of the 1930s, when the tariff barriers went up and there were

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<sup>2</sup> <https://www.youtube.com/watch?v=n3UJ6yMaM4A> - Debt bomb: Are we on the brink of another global financial crisis? - ABC News (Australia)

currency wars and competitive devaluations. That ultimately lead to some nasty geopolitical tension.

Thus, his perspective is that though the next recession is likely, its scale is smaller than the last time and the vulnerabilities are different. We can attempt to avoid it but the methods are not very straightforward or guaranteed to work, though we must do so anyway.

As to where the financial crisis will begin the matter of where it will begin is also likely to be different than last time. The last big financial downturn was in the US with the collapse of the housing bubble there. Next time it's much more likely to start elsewhere, somewhere in the emerging world. These economies possess a much larger share of the global output than they used to. They have also gone on something of a 'borrowing binge' over the last 10 years which means that they could be due for a reckoning.

There are also reasons to be concerned about the Euro area, in particular Italy which has an enormous debt problem and the market has been slightly jittery about its ability to pay that back. That could relaunch the Euro area debt crisis that was solved around 5 years ago.<sup>3</sup>

Raghuram Rajan, former RBI governor of India, agrees with aspects of this perspective such as that much of world growth is determined by growth in emerging markets. The Industrial world cannot be decoupled from emerging markets. We need both to grow, we have an illusion that industrial countries are growing strongly and that it doesn't depend on emerging markets. He focuses, however, on a different set of vulnerabilities that he feels are most likely to shape the crisis.<sup>4</sup>

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3 <https://www.youtube.com/watch?v=rD7KNVzkLPw> - How to prepare for the next global recession | The Economist

4 <https://www.youtube.com/watch?v=y4x9FM6jyCc> - Raghuram Rajan Reveals It All | Exclusive Interview | NPAs, EMs, CAD & Currency Crisis | CNBCTV18

He suggests that there are two big sources of vulnerability that have built up. One is the leverage that has built up across the globe, not just in flows to emerging markets but also within industrial countries: there are sectors that have become very highly levered. In Australia the housing sector, in the US the shale sector – these are highly levered. Pockets of leverage have built up across the world just as they did before the 2008 crisis.

The second source is policy. Trade tends to dampen cross border investment and also affects sentiment. Couple these together and what you have is a possibility that when a country is already vulnerable, there's an additional political shock that comes from the trade side.

On top of all this there are interest rates rising. The Federal reserve will likely continue raising interest rates as US employment numbers is rising and inflation is picking up. There is little confidence that the US administration is worried/ aware of this feedback reaction throughout the world.

Last time the Fed was raising rates, the US economy was doing well, Asian markets could export to it. Now they have the negatives of the US economy – strong dollar and higher rates but the Asian markets cannot export to them as much due to increasing barriers. It is thus a big source of uncertainty. India, on the other hand, is different, it is a more of a self contained economy.

Monetary policy cannot be the answer to everything. In the West, unfortunately, it has been very low for very long, it has built up vulnerabilities. Now, as it normalizes, we are seeing the consequences of those vulnerabilities.

There are numerous economists who, on the other hand, argue that a great recession is not coming any time soon, and they provide differing arguments for their stance.

David Rubenstein (Co-founder of the Carlyle Group) remarks that he has been saying for sometime that we are going to experience another recession but he doesn't see it coming. He states that the signs that he has from his companies. All of the 275 companies around the world seem to be doing pretty well. He thinks that the economy

is in reasonably good shape and will increase by two more 25 basis point increases this year without any real disruption.

Yuwa Hedrick-Wong, *ex-Global Chief Economist and Chair of the Academic Advisory Council at Mastercard and Visiting Scholar at the Lee Kuan Yew School of Public Policy, National University of Singapore*, argues the same, but approaches the topic from the perspective of the Chinese economy, stating that beliefs about China's slowing economy is more myth than reality and presents a number of reasons for why he believes so. In 2007 China's real GDP growth climaxed at 14.2%. Ever since it has been trending downward. By 2017, it dropped to 6.8%. That much is clear. He argues, however, that other factors such as the decline of the Chinese stock market, is a signal that the slowing economy is being affected by the trade war.

He contends that the unlike the US, China's stock market has few substantial links with the rest of the economy. The second myth is that slowing economic growth has led to its currency weakening but the truth is that it is not just the Chinese yuan that has declined against the US dollar, but also the Indian rupee and euro have also decreased, to name a few. Lastly, there is the myth of the imminent crash of the Chinese economy (due to debt overhang). He suggests that crucial facts are left out such as the fact that most of China's debt is domestic and most is owed by public sector enterprises to state owned banks.

Furthermore, China dealt with a worse debt situation in the 1990s and can do so again. He takes a view against Raghuram Rajan and Ryan Avent, suggesting that a high level of debt by itself is not a problem if it is productively invested. The optimal solution to China's debt overhang is to slowly increase productively invested debt. Thus he suggests that the emphasis on deleveraging is more exaggerated than need be. <sup>5</sup>

John Mauldin instead focuses on the vulnerabilities of the American economy: they have a deficit that is already running a trillion dollars today, could "'easily' be running a trillion five, a trillion six" during a recession when automatic stabilisers will have kicked

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5 <https://www.forbes.com/sites/yuwahedrickwong/2018/08/15/the-myths-about-chinas-economic-slowdown/#1657c655d550> – The Myths about China's economic Slowdown – Yuwa Hdrick Wong - Forbes

in. There will be a revenue decline and increased spending. That would a 7 to 8% deficit of GDP. Fiscal irresponsibility will create a dollar crisis which will radiate through the world. <sup>6</sup>

Ray Dalio suggests that the problem with debt is that most countries do not have debt denominated in their own currency. He suggests that the current period is similar to the period between 1935 and 1940. In 1929- 1932 we had a debt crisis, interest rates hit zero. 2000 – 2007 is very similar to that period. There's only one thing for central banks to do- buy money and print financial assets. This pushes financial assets up and puts liquidity in and contributes t a greater wealth gap. In result, both periods of time, there's populism. That populism issue is an important issue. We will have a kind of downturn that the Fed and other central banks are beginning to tighten monetary policy. Asset prices are sensitive to monetary policy. His argument is similar to Raghuram Rajans' focusing on the political shock which may further impede the global economy's progress.<sup>7</sup>

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The reasons put forth for the imminent occurrence of the next global recession include shadow banking in countries such as China and India, the lack of resolution of problems that caused the 2008 crisis, the fact that action against financial malpractice has not been tough enough and debt crises in countries such as Italy. There are strong counter arguments against why a recession may not be imminent such as the fact that China's slowdown in trade is overemphasized, the US economy's expansion may continue to grow as it is looking fairly strong as of now, debt is not as threatening of a problem as it s made out to be ad countries such as India are relatively insulated from

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<sup>6</sup> <https://www.forbes.com/sites/johnmauldin/2018/03/20/the-next-recession-might-be-worse-than-the-great-depression/#5cf8d0be69b9> - The Next Recession Might Be Worse Than The Great Depression John Mauldin (a financial writer, publisher, and New York Times bestselling-author.)

<sup>7</sup> <https://www.youtube.com/watch?v=Nm0m62reFuY> - Dalio on Turkey, Argentina, and the Next Economic Downturn- Bloomberg Markets and Finance

the world economy. In my opinion a recession is likely by 2021 but not on the same scale as the 2008 crisis and it certainly can be mitigated by multilateral and governmental action. It is similar to the 1935-1937 period. In writing this essay, I have found that other interesting questions could be further explored (which I have touched upon) such as where the crisis may originate, whether crises are an inevitable part of global economic cycles, and just how big a factor is the increasingly globalised nature of the world economy. Before I started this topic, I was unaware of the extent of likelihood of another global recession and was surprised to see how many reputable economists, websites, and magazines had written about and subscribed to the idea.

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