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2009 - Just how deep will the recession be?



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He is managing director of several major client groups and senior consultant to some 250 client companies such as AIG, Cadbury Schweppes, Coca Cola, Dow, Ernst & Young, GlaxoSmithKline, Hewlett Packard, IBM, KPMG, Motorola, Procter & Gamble, PepsiCo, Oracle and Unilever. In this capacity he visits company headquarters to provide in-house consultation on business at regional manager and CEO/chairman level. He also writes each year 10-12 global position papers which are distributed to 2,000 client executives.

Dr Thorniley also teaches occasional MBA courses on behalf of Oxford University, the University of Chicago, Instituto de Empresa, IESE and the Central European University in Budapest. The executive MBA students at Chicago have rated him “best speaker” on 12 occasions out of 12 over 5 years.

He worked for the United Nations in Vienna as the United Kingdom representative from 1983-86 in a unit working on East-West economic and political developments.

He has published three books, including one on Russia with Macmillan (UK/USA) and one with Profile Books on Doing Business in Global Emerging Markets.

He is the very proud father of his 20-year-old daughter called Natasha.

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> More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other to total extinction. Let us pray we have the wisdom to choose correctly.
>
> with thanks to Woody Allen

Food for thought

A question: on any television or press interview that you have seen in the last six to eight weeks, have you heard one single banker utter the words, "Thank you" for the trillions of dollars that have been poured into the system by the state and the taxpayers (teachers, bricklayers, nurses, cleaning ladies, you, me) to save them? I have not.

In the last six weeks there have been a couple of occasions when the global financial and economic system was within 36 hours of the start of total implosion and collapse.

Writing on October 15th 2008 there is still a 25% chance that the whole global system will collapse. If this comes to pass, we will see the automatic nationalisation of the entire global banking system. This nationalisation process is already underway but not yet total. This nationalisation scenario would be the last safety net before total endemic collapse.

2009 is going to be a year of global recession. The only debate is about how deep and long the recession will be. Some commentators talk of a 10-year recession for some economies.

The UK spending on the financial crisis to date could have instead built 2,500 schools and 800 hospitals. This is the opportunity cost. Those schools and hospitals will not be built in the UK or elsewhere in the world as personal, corporate and state budgets are cut to get through the incumbent recession.

Someone said to me the other day, "Aren't you worried that if the banks are taken over by the state that decisions made will be political ones". Possibly, but, then again, on balance I think I prefer political decisions to the incompetent financial/market ones that have left us exposed to a $66 trillion derivative market which no one alive today quite understands.

Reports indicate that in terms of the money expended as a proportion of GDP globally, the current crisis is not as deep as that in 1929 or even some crashes in the 1980-90s. But we are still in the eye of this storm.

Global economic outlook

This part of the paper looks at the economic outlook; the next section will explain what is causing this outlook.

Everything depends on whether interbank lending loosens up in the coming weeks and on whether the Libor rate falls. If it does we will just have a recession in 2009; if it does not, then we are in for something worse.

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The crisis started last summer to manifest itself in the US housing market and sub-prime mortgages; it then morphed into a financial crisis and meltdown and now is contaminating the real economy, which was already fragile thanks to a weaker housing market and soft consumer confidence. The global slowdown is contributing to a collapse in commodity prices, which will hurt demand in several emerging markets. As ever, the markets are over-reacting now on the downside after doing so on the upside for several years.

Global GDP growth 2009-10

	2009			2010
	Best	Middle	Worse	
Global	3.5	3	2.6	3.9
Emerging Markets	6.3	5.2	4.5	6.9
USA	0.1	-0.2	-1.5	1.2
Eurozone	0.0	-0.4	-1.7	1.0
UK	-0.2	-0.5	-1.8	0.8
China	8.8	8.2	6	8.8
Russia	5.8	5.2	4.3	5.5
CEE (excluding CIS)	4.6	4.0	3.2	4.5

Source: the author

Emerging markets will be the relative saviour of the global economy going forward. But they too are being hit and while they will be growing 5-10-12 times faster than western economies, it will still feel like a cold bath for companies. Capital flows to emerging markets were $750bn in 2007 and about $710 this year; this amount should fall to less than $500bn in 2009 and will pressurise those markets which most rely on foreign finance.

Emerging markets which are commodity producers will be badly hit and that includes Russia, Latin America and the Middle East. Commentators felt that the Middle East would be the most immune region, but emergency financial measures were introduced in UAE/Dubai.

Asset prices and stock markets have been savaged in Asia, but China looks the most resilient economy – and can boost flagging export growth through fiscal policy to help domestic demand via more spending on health and education. The Asian region as a whole shares several of the positive points in the CEE region: low level of debts, generally good balances in budgets and current-account positions and a greater reliance on domestic demand which may just cushion Asian economies as exports decline globally. Latin America as a region is better protected than in the past, but the exposure to the US market and tumbling commodity prices have started to hit the markets hard since August when currencies and stock markets plummeted.

The CEE region is buttressed by buoyant domestic demand, EU funds, and relatively small banking exposure except through central offices of western banks. There is export exposure to the faltering EU: CEE exports to EU did weaken this year when in the past they had been strong despite the strong CEE currencies. Poland, Czech Republic and Slovakia look the most solid and resilient markets, whereas the Baltic States, Hungary and Romania along with Bulgaria are the most vulnerable. Ukraine is also coming under severe financial pressure, and the spreads on its debt are such to indicate a high risk of default. The intensification of the crisis is seen in the need for IMF support for Hungary and Ukraine and an ECB credit facility for Hungary. Hungary and other markets are facing repatriation of private capital to the West and difficulties in raising local financing.

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The big issue

The major central banks are pumping trillions of dollars into the financial markets, governments are recapitalising banks and ensuring their solvency, guaranteeing deposits and moreover guaranteeing bank borrowing. But after a sharp blip upwards this week, why are stock markets down again? That question is the easy one: the markets now realise that a harsh recession is ahead of us and the stock value of non-bank companies are starting to tumble further such as General Electric, Caterpillar, along with the energy companies as the oil price falls. The stock market contagion has hit the non-financials and global stock markets will remain weak throughout the next 15 months.

But it is more worrying that, despite all these efforts by central banks and governments, the interbank credit markets are not opening up and the spreads on three-month Libor (the most important interbank lending rate, that is used to price loans, derivatives and other financial products), has barely moved in the UK where there has been more than a week to adjust to the government's measures: sterling three month Libor is currently 6.25% and Euro-Libor is at 5.225% while the dollar three month Libor has fallen a little to 4.635%.

In recent conversations with senior Austrian bankers, I was informed that over each weekend Boards of the major banks meet separately to discuss the market opening on Monday morning and talk of how their competitors will go bust during the coming week. The Boards of the various banks simply do not have faith in their competitors; they are frightened of what exposure is left in the financial markets; they are unsure of who has that exposure and they do not believe what their banker colleagues tell them; trust has broken down. This is happening in Austria each weekend and in every other major market.

Why are the banks then not lending to each other when there is nothing further to fear? Well, there is fear of what Warren Buffet once famously called "the financial instruments of mass destruction", that is, derivatives and credit default swaps (CDSs); the latter are a type of insurance on the derivatives. While governments globally have perhaps utilised and made guarantees worth up to $4 trillion so far, the derivatives market is valued at $600 trillion and the credit default swap market is reckoned at about $55 trillion (give or take a few trillion). What is more disconcerting is that there is great uncertainty about what these numbers mean: will someone owe these amounts? Or will the eventual costs be netted out and the ultimate cost be measured in mere billions rather than trillions? These are the fundamental uncertainties that have stopped the system.

To use one analogy:

> The governments are pouring blood (money) into the heart, but it is not flowing from the heart through the veins (into the economic system and business). The overnight wholesale banking system cannot function at these exorbitant rates over Libor. Banks won't lend to banks and are halting lending to companies.

If the interbank lending market does not open up and if Libor rates stay at 4-6%, then either the governments will have to introduce a mandatory system to lower rates to 2-3% and/or more likely this will accelerate the process of total bank nationalisation. When the governments own the banks, then they can set their own rates for their own nationalised banks. Two weeks ago, I thought this very unlikely; today I think it possible.

> The bankers through their greed and stupidity (with a few exceptions) were the initial cause of the problem and now they are the problem blocking the solution

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> which has been provided by states at the cost of trillions of dollars. Can these bankers do nothing right?

In mid-October it seemed that the netting out of credit default swaps after the collapse of Lehman could mean that only about $5-10bn change hands and not upwards of $400bn. That news on Lehman would be welcome and, given that governments have guaranteed that there will be no more Lehmans, then the banking sector ought to take comfort quickly. If the resolution of the Lehman case for CDSs is the end of the affair, then this would signal a reasonably early resolution for the banking sector in the coming weeks and run in to year-end. But if the banking sector still feels that the CDS issue is unresolved, then there are grave threats to the global macroeconomy.

The concerns abound: the two British banks Barclays and Royal Bank of Scotland (RBS) each hold a stunning $2.4 trillion of CDSs. How will that unravel when one of them is nationalised (RBS) and the other not? The potential exposure here seems to be six times that of Lehman: will it mostly net out again … or not? Buying new contracts to insure against default of the original derivative has become prohibitively expensive. Securitisation and insuring against risk has effectively stopped.

The corporate bond market is headed in the same direction. When banks won't lend to banks, then they soon stop lending to corporates. General Electric is one banner-head company which has come under pressure to finance its operations. GE was forced last week to halt its capital paper program and suspend its stock buyback plan to help ensure its triple A credit rating. The chief of Siemens financing arm has complained, "it is impossible to refinance at attractive rates". This was said a few days ago; it might soon be impossible to refinance at any rates, let alone "attractive" ones. Carlos Ghosn, CEO of Renault, has said, "The credit markets are practically frozen and even healthy companies are having trouble finding finance". Commercial paper markets are equally stuck in the US and Europe. Cadbury, the UK confectionary company, recently drew down Ł1bn on a revolving credit facility (sort of overdraft) to refinance short-term debt because of the illiquidity in the commercial paper markets. But this is what the government programs instituted in recent days aim to resolve.

What if Libor rates do not come down?

If they do not, there lies the potential for complete financial and economic implosion. Banks will not lend to each other, credits to companies will freeze; banks will go out of business, equity markets will have to be closed, corporate bankruptcies would boom. This would take us into deep recession territory (worse than the worst case above) and then the final safety device would be the nationalisation globally of the entire financial sector. This would save the global system from complete implosion; that's the good news, but the procedures would take months to sort out. There would be salvation of sorts in 2010-11 with economic stability at lower rates of growth. But given the uncertainty it would create (and this type of uncertainty over details of the system is preventing any consistent pick-up in the UK), it would entail a very deep and brutal recession during 2009.

In recent days in the UK British bankers were quibbling with the UK government over the terms of the recapitalisation. The bankers don't want the governments' preference shares to be, well …, so preferred; in other words they want dividends to be paid to shareholders sooner than the government wants and even before the government is paid back. This argument stems from the fact that the government's stake in the banks is intended to be short-term.

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But if this quibbling continues, confidence will further evaporate and the UK government (and others) will soon be buying up nearly all banks for the medium-long term. The bankers may talk themselves into full nationalisation. There are even some naďve/arrogant banking souls in the UK who think they can still raise sufficient capital to shore up their reserve requirements by themselves. This looks a long shot to me.

Just to underscore the churlish nature of the bankers, Angela Knight, CEO of the British Bankers' association, has said, "This is not a nationalisation policy". Technically you can quibble whether preference shares are loans or capital (they are the latter but look like the former). No mention has been made yet of warranties and equity stake with voting rights but these just may be round the corner.

Note: the good news is that as of Friday 16th October, Libor rates are creeping downwards daily. But the reduction is still moderate and rates today remain high. If the rates fall further each week, the one remaining block would be psychological fear among bankers who would need to be pushed in the right direction of lending more. Interestingly the Austrian National Bank held a summit of Austrian bank chiefs two days ago to bang heads together. The National Bank was extremely frustrated at the tone of the meeting, i.e. one of distrust.

What else can be done?

The UK model, which has been copied globally, entails

1. injecting fresh equity to restore banks' solvency, in the UK case up to Ł50bn through preferred shares or by underwriting issues of ordinary shares;
2. providing more liquidity to the markets – another Ł100bn in the UK added to an original Ł100bn; and
3. guarantees in the UK up to Ł250bn of new medium-and long-term bank borrowing.

One thing the UK has omitted, unlike the Americans, is the creation of a "bad bank" with a fund of, say, Ł200 that will acquire the worst debt from distressed British-based banks. It could hold such debt for up to 20 years, aiming to sell it at a better price in the future.

Globally the authorities thankfully have a couple of other instruments at their disposal which they should use quickly. The central banks can simply continue to flood the markets with money until banking confidence returns. The usual effects of such soaring national debt levels would normally make the relevant currencies vulnerable but today this is moot as nearly every major economy is doing this – currency speculators (why don't we do something about them as well? Shoot them?) cannot attack all currencies, all the time. Put another way: no currency will be particularly weakened relatively; they all will be.

By the same token, flooding markets with capital ought to cause rising inflation but this too is moot as the flood of money will happen against a backdrop of recession.

Moreover, if inflation rises, it will not be in any one particular economy but everywhere. But inflation ought not to rise so much because the flooding of the financial markets with money is not the same as printing money for consumption: much of the money issued in the form of guarantees may never actually be used or paid back in full or in part eventually. In any case, today stagnation and collapse are the first priorities, not inflation.

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The central banks will also have to start to cut interest rates savagely. At the time of writing (14 October 2008) central rates are:

	Mid October 2008	My estimate 31/12/08	Mid 2009 "ought to be"	Likely
USA	1.50%	1.00%	0.25%	0.25%
UK	4.50%	4.00%	1.00%	2.50%
EU	3.75%	3.25%	1.25%	2.50%
Japan	0.50%	0.50%	0.10%	0.25%

The central banks need to deliver a clear message through interest rates that they recognise the risk of debt deflation, disinflation and major recession. I wonder if they are up to this even now. The US Federal Reserve usually performs best on being pro-growth and the ECB will fail this test as it has with most others.

Slashing interest rates ought to be part of a concerted approach to mitigate the economic downturn which stems from the collapse in the housing markets. Much attention and money has been given to the financial sector but not enough done for the housing market. I do not mean that governments should act as underwriters for a bubble-booming housing market, but rather shore up limited confidence and prevent collapsing housing prices taking consumer confidence down even further. In addition to much lower interest rates, comprehensive legislation needs to be promulgated now to protect home-owners from being evicted from their property. Such foreclosures merely aggravate economic malaise, boost unemployment and raise social security spending for the state. Little has been done so far in any systematic fashion. A moratorium on foreclosures is needed.

And when governments do start their economic regeneration/reflation programmes to lessen the economic recession, they can take a leaf out of the Australian book. Last week's Australian economic stimulus package (perhaps a first instalment) consists of $7bn which is targeted at those people who will want to spend the money quickly: first time home-buyers, the poor and pensioners who need to buy food and clothing. In the past stimulus packages have often been too broad in the scope of those who benefit, especially in the USA; if money is thrown at the rich or middle class, they have a tendency to save it or invest it rather than spend it. Spending is what is needed now.

Whatever scenario develops for the global economy, one thing is for sure: the global banking business will be 20-25% smaller than it was in 2007 as certain types of business virtually disappear.

The coming weeks will see endless pumping of liquidity into the markets, falling interest rates and further recapitalisation/nationalisation of the banking sector.

Low esteem of bankers could help house burglars

As everyone knows people are running to take their money out of the banks. This week the value of Euro bank notes in circulation jumped by 2.7% (in one week). This is due to the ECB

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pumping liquidity into the system, but also to individuals taking money out of the banks. My own Austrian banker told me today that people are taking cash out of all Austrian and European banks at unprecedented levels. He noted that, "Several of our clients are walking out of the bank with one or two million Euros in cash to hide at home. We advise them against this, but they don't listen". The unintended consequence of people stashing millions under their mattresses is a boom in business for house burglars; actually it is a sociological fact that most people hide their cash in the underwear drawer (not under the mattress) which is of course the first place that burglars look.

How are the authorities shaping up in the crisis?

Score card (out of 10) for how governments and central banks have responded to the crisis:

	Initially	By mid-October 2008
UK	3/10	10/10
USA	6/10	9/10
Eurozone	1/10	7/10
Russia	6/10	10/10

The UK government initially dithered, but had learned lessons from the nationalisation of Northern Rock earlier in the year. Once the crisis deteriorated, the UK authorities delivered the best plan on Monday 6 October. The market response over the last two weeks has been disturbing. One could argue that this was initially because this took place in isolation, but one week later (Monday 13 October) Europe and the US followed suit and still stock markets collapsed and lending failed to flow.

The US authorities were ahead of anyone in bringing down interest rates and pushing massive amounts of liquidity into the system, but this too had limited effects. The original Paulson Plan looked solid but it clearly only addressed the issue of toxic debts; within days it became clear that more was needed. The poor US authorities are/were hamstrung by ideological factors. It soon became apparent that more "nationalisation" (after AIG) was necessary, but the political system balked at this (never underestimate the stupidity of a USA Congressman/woman) and the US lost precious days. The State is now in the process of recapitalising/nationalising some banks.

The Russian authorities did a good job, but to little effect. They learned from their mini banking crisis in 2004. But foreign investors have fled and local ones are trapped by margin calls. The State is about to use Federal funds to stop the rot. The western rating agencies may declare against this, but the government is rightly less interested in what these incompetent organisations have to say.

The Eurozone and ECB have performed the worse to date because of initial lack of coordination, governments announcing single ad hoc guarantees, confused messages coming out of Germany and the inimitable European Central Bank still fretting in the corner about inflation when the whole Eurozone economy is about to die. The European Commission should now be laying the groundwork for a state role in the recapitalisation of European banks; EU rules on state aid will have to be updated or they will simply be ignored in practice.

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Currencies start to fly around

The currency markets are also starting to get out of control and to gyrate wildly: the Australian dollar for example fell about 20% in one day against the Japanese yen. The currency markets though, like the economies, ought to prove a competition of misery: should you really sell the British pound for Euros? Is Japan's economic outlook really better than other developed economies? And so on.

A major fall in the US dollar now would not be helpful, but we think that this is unlikely because:

- other governments are issuing huge amounts of debt;
- the US can probably issue another $2-3 trillion before any intrinsic run on the dollar would be valid;
- China and Japan are nursing hundreds of billions of paper losses on the dollar and would be loath to be involved in any "rush to the door" to get out of the dollar. Hence why they will keep it up.
- With tight credit markets in the US, institutions in the US have been buying dollars abroad (at high interest rates). This explains why the dollar was rising when the US financial system was on the verge of collapse.
- Eurozone governments have not been issuing many bonds,
- and finally the markets have been running to the security of "Mummy" – the US dollar – in times of crisis and with this "competition of misery", why not indeed?

The business world

Western companies have been able to ride out some of the current storm thanks to sitting on large cash piles of profit, but the business mood globally and within emerging markets and in CEE has soured noticeably in recent weeks as weaker business results start to flow in on the back of deteriorating economic statistics almost everywhere. Business will be badly hit for the rest of 2008 and the whole of 2009 as global demand slumps. Unemployment is rising in the developed markets, house prices are collapsing in several major economies and consumer confidence indicators are sinking. Global demand was already fragile in the spring of this year, but will now get much worse.

Fragile consumer confidence and overvalued assets are now combining with the financial meltdown. In the last four to six weeks the two tidal waves have combined:
construction, real estate and the automotive sectors have already been knocked hard; the impact on overall consumer spending has started and is showing up in retail spending figures and corporate results.

Companies are holding emergency planning meetings, adopting scenario budgets and /or not committing to make their plans public to the market (and so avoid having their shares trashed even further). Contingency planning is the mode of the day. Discretionary spending is being halted, travel budgets pared and deeper cuts planned. The good advice of showing loyalty to staff through hard times will probably be ignored as companies have already started down-sizing, most in the West and bringing in shorter hours in the CIS.

Consumers will move even further down-market and look to discount stores. Companies will engage even more in savage price wars. The closer companies are to food, then the easier it will be, but not so easy. Non-food consumer goods were already under pressure in Hungary and Turkey and are falling further and this trend is hitting other CEE and global markets.

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Consumer electronics sales will suffer. Companies will look to promote premium brands and ensure innovation, but it is the wealthy in many markets who have been the worst hit by the markets turndown, so luxury goods and premium brands will not escape. Continuing an existing trend, middle brands will be most badly hit in the next 18 months as most consumers turn to discount products and a shrinking minority can still afford premium brands.

In very solid markets such as Russia, the threat is that, even though consumers still have lots of money, the credit squeeze could cripple distribution channels. Retailers could come under threat. If banks start to go bust, public confidence could shake. Demand is still there, but accessing it is increasingly the problem.

In Central Europe many companies have said that as a region overall, things were still going very well until the end of August and the beginning of September. But since then more companies are reporting softer results: IT companies note that B2B slowed markedly in recent weeks and there is concern over government spending in the coming quarters. The credit squeeze in Russia and Ukraine (two big-volume markets) has started to hurt and, in addition, sales in Hungary deteriorated from an already fragile position; the recent 15% fall in the forint this week exacerbates concern (as we have argued, the forint thankfully was coming from a high position). A one-day stock market closure in Romania has also spooked business. The Baltic States look highly vulnerable. We flagged several of these issues earlier in the year. The point is that a severe crisis in the Baltic States and Romania ought not logically to damage other more solid economies in the CEE region, but in this current environment, any crisis will spread.

A number of senior CEEMEA regional executives in manufacturing companies have also complained to me along the following lines, "This global crisis is actually a god-send for some average and weak executives at global headquarters. They have performed poorly in their developed markets in recent times, not adapted well there and not understood how to develop and invest properly in our emerging markets region. We could have done better without them. But now rather than being booted out, they can blame everything on the global crisis and survive which won't do our companies any good in the future".

Where is the upside?

Well, apart from house burglars acquiring all that cash, there are some benefits:

- Slower inflation will help companies a lot. Input prices will start to fall and companies will be less obliged to jack up prices on sceptical or frightened consumers, which is where we were just a few weeks ago.
- Weaker competitors will go to the wall.
- Consolidation will increase once the dust settles.
- Winning companies will be able to acquire future market share by buying out competitors or simply through their disappearance.
- There will be less competition from emerging market companies as they nurse their loses and are less confident.
- With price/earnings ratios at 6-8 in the UK and the USA and 3-5 in Russia, now looks like the time to buy in. (If you do so on this advice, and lose all your money, do not blame me!)
- Buying cheap assets does look like a winner but only for the brave.

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The crisis could have several implications for human resources and talent management:

- It will take the steam out of salary inflation.
- Russian companies now will not be spiking up salary averages and creaming off the very best managers.
- It could take confidence out of employees who will now make less aggressive demands on starting salaries or salary increases.
- Employees will probably remain more loyal and not want to job-hop so much when companies are down-sizing or threatened with closure.
- Many western companies will be slowing overall investments and this will mean less need for new staff.

Scenarios

1) If inter-bank lending loosens up, rates over Libor fall and companies can access reasonable amounts of credits at reasonable rates, then the recession ahead will be a severe one in 2009, with the start of a pick-up in spring 2010.
2) If they take much longer to loosen up, then the 2009 recession will be very harsh and last through until at least the third quarter of 2010.
3) If there is a failure to open up credit markets, the system will start to collapse. This will entail massive bank nationalisation, which will stop the total implosion, but will require months for a new effective system to operate. This would mean a deep retrenchment on a global scale; 2009 would be the worst year for global growth since the second world war and it would take 2-3 years at least before the global economy came back; some economies would go into a three-to-five-year slump.

Conclusion: day by day

The new and excellent Nobel Prize winner for Economics, Paul Krugman, said on Monday October 13th that he felt that the chances of avoiding the "deep catastrophe" had improved since the previous Friday October 10th (thanks to global government intervention over the weekend). On Tuesday October 14th I agreed with him entirely, but on Wednesday October 15th, I am less sure, and I am sure he is thinking the same. The scene is changing day by day. We will only be able to gauge whether we enter a firm recession or a very harsh one or plunge into a catastrophe over the coming weeks/months. Certainly, when we raise our sherry glasses on Christmas Day, we should know what the future holds and whether we have one.

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