

Mission impossible: stop another recession

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Another recession may not be preventable. But policy can stop a second depression.

The first half of 2011 showed a slowdown of growth – if not outright contraction – in most advanced economies. Optimists said this was a temporary soft patch. This delusion has been dashed. Even before last week's panic, the US and other advanced economies were odds-on for a second severe recession.

America's recent data have been lousy: there has been little job creation, weak growth and flat consumption and manufacturing production. Housing remains depressed. Consumer, business and investor confidence has been falling, and will now fall further.

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Across the Atlantic the eurozone periphery is now contracting, or barely growing at best. The risk that Italy or Spain – and perhaps both – will lose access to debt markets is now very high. Unlike Greece, Portugal and Ireland these two countries are too big to be bailed out.

Meanwhile, the UK has seen flat growth as austerity bites, and structurally stagnating Japan will recover for a few quarters – after double-dipping after the earthquake – only to stagnate again as the stimulus fizzles out. Even worse, leading indicators of global manufacturing are slowing sharply – both in the emerging economies like China, India and Brazil, and export-oriented or resource-rich countries such as Germany and Australia.

Until last year policymakers could always produce a new rabbit from their hat to trigger asset reflation and economic recovery. Zero policy rates, QE1, QE2, credit easing, fiscal stimulus, ring-fencing, liquidity provision to the tune of trillions of dollars and bailing out banks and financial institutions – all have been tried. But now we have run out of rabbits to reveal.

The misguided decision by Standard & Poor's to downgrade the US at a time of such severe market turmoil and economic weakness only increases the

chances of a double dip and even larger fiscal deficits. Paradoxically, however, US Treasuries will probably remain the world's least ugly safe asset: risk aversion, equity declines and a looming slump could even see treasury yields fall rather than rise.

Fiscal policy is now contractionary in both the eurozone and the UK. Even in the US the issue is only the amount of drag, as state and local authorities, and now the federal government, cut spending, reduce transfer payments and (soon enough) raise taxes. Another round of bank bail-outs is politically unacceptable. But even if it were not, most countries, especially in Europe, are so distressed that their sovereign risk is actually leading to banking risk – as banks are loaded up with distressed government debt.

Hopes for quantitative easing will be constrained by inflation that is well above target levels across the west. The Federal Reserve will probably start a third round of QE, but it will be too little too late. Last year's \$600bn QE2 (along with \$1,000bn of tax cuts and transfers) produced a growth bump of barely 3 per cent, for one quarter. QE3 will be much smaller, and will do much less. Nor will exports help. All advanced nations need a weaker currency, but they cannot all have it together – if one is weaker another has to be stronger. This is a zero sum game which risks only the resumption of currency wars. Early skirmishes are beginning as Japan and Switzerland try to weaken their exchange rates. Others will soon follow.

So can we avoid another severe recession? It might simply be mission impossible. The best bet is for those countries that have not lost market access – the US, UK, Japan, and Germany – to introduce new short-term fiscal stimulus while committing to medium-term fiscal austerity. The US downgrade will hasten demands for fiscal reduction, but America in particular should commit to look for significant cuts in the medium term, not an immediate fiscal drag that will worsen growth and deficits.

Most western central banks should also introduce further QE, even though its effect will be limited. The European Central Bank should not just stop rate hiking: it should cut rates to zero and make big purchases of government bonds to prevent Italy or Spain losing market access – the outcome of which would be a truly major crisis, requiring doubling (or tripling) of bail-out resources, or debt workouts and a eurozone break-up.

Finally, since this is a crisis of solvency as well as liquidity, orderly debt restructuring must begin. This means across the board reduction on the mortgage debt for the roughly half of America's households that are underwater, and bail-ins for creditors of banks in distress. Greek-style coercive maturity extensions, at risk free rates, must also come for Portugal and Ireland,

with Italy and Spain to follow if they lose market access. Another recession may not be preventable. But policy can stop a second depression. That is reason enough for swift and targeted action.

The writer is chairman of Roubini Global Economics, professor at the Stern School, NYU and co-author of Crisis Economics