

Fighting the next world recession

Policymakers in rich economies need to consider some radical approaches to tackling the next downturn

The Economist, Feb 20th 2016

AT THE start of most years in the past decade, the list of worries about the world economy has seemed longer than that of reasons for hope. The first few weeks of 2016 have upheld this new tradition. Many emerging markets are wrestling with excessive debts, slow growth, plunging currencies and rising inflation. China, the world's second-largest economy, is a source of a peculiarly intractable anxiety. If its growth falters, it stokes worries about the prospects for other emerging markets; if activity holds up, though, concerns shift to the ever-rising debt that makes such feats possible, but not necessarily sustainable. The euro area's troubles are no longer acute; but a chronic condition with an uncertain prognosis is a hard thing from which to take much cheer.

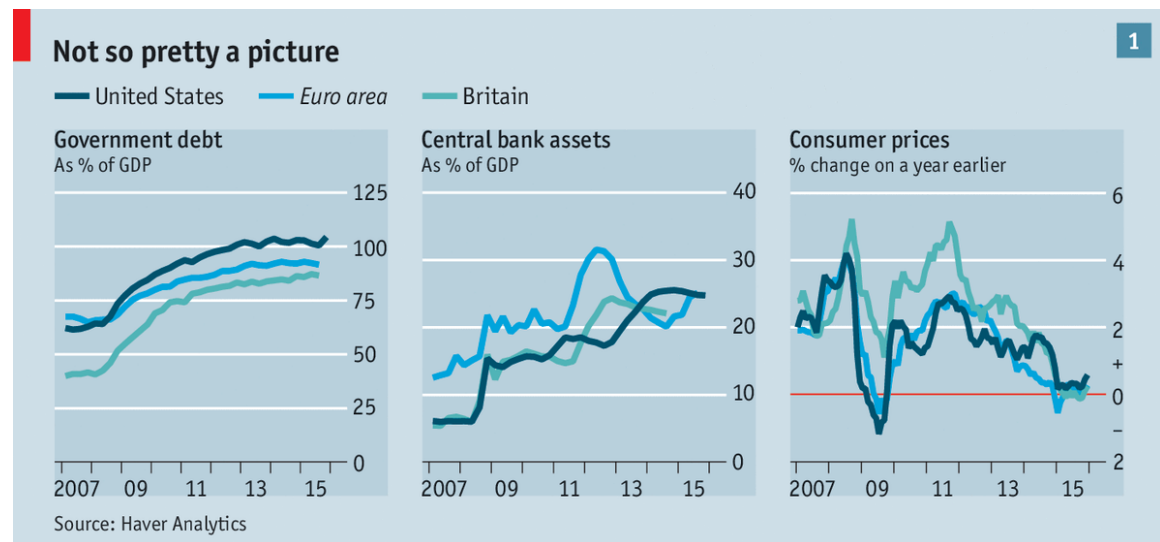
The one big hope has tended to be the American economy. Some indicators there remain robust. The housing market shows few signs of weakness. New jobs are still being added. But despite this, signs of impending recession are now piling up. Economic growth seems to have stalled in the final quarter of 2015. Corporate profits are falling. Stock levels are above normal. Lending standards on bank loans to big firms have tightened, according to the Federal Reserve. A closely watched index from the Institute for Supply Management (ISM) shows that activity in manufacturing fell for the fourth consecutive month in January (see [article](#)). The malaise is not confined to factories: the ISM non-manufacturing index is at its lowest for almost two years.

The growing anxiety is mirrored in financial markets. Stockmarket indexes have fallen, dragged down in particular by bank stocks, which have lost 16% of their value (in America) since the start of the year. America's economy is not strong enough to buoy the world economy up; it may not even be strong enough to keep itself afloat.

Pessimism among investors reflects not just the indicators pointing towards recession. There is a deeper concern that, if or when that recession comes, policymakers will have very few options for dealing with it. Short-term interest rates are close to zero in most of the rich world. The scope for adding further pep through quantitative easing, (QE, the purchase of government bonds using central-bank money) is limited. Long-term interest rates are already low; driving them lower with another round of QE is unlikely to invigorate aggregate demand much more. Tax cuts or increases in public spending could still be effective in fighting recession. But investors worry that there is little scope or appetite for financing a fiscal stimulus with yet more debt. Public debt in America rose from 64% of GDP in 2008 to 104% by 2015; in the euro area, it rose from 66% to 93%; in Japan, from 176% to 237%.

If policymakers appear defenceless in the face of a fresh threat to the world economy, it is in part because they have so little to show for their past efforts. The balance-sheets of the rich world's main central banks have been pumped up

to between 20% and 25% of GDP by the successive bouts of QE with which they have injected money into their economies (see chart 1). The Bank of Japan's assets are a whopping 77% of GDP. Yet inflation has been persistently below the 2% goal that central banks aim for. In America, Britain and Japan, unemployment has fallen close to pre-crisis levels. But the productivity of those in work has grown at a dismal rate, meaning overall GDP growth has been sluggish. That limits the scope for increases in real wages and in the tax receipts needed to service government debt.



Economist.com

It is tempting to put this disappointing return down to the untested policy instruments wielded by central banks which played so prominent a role in the response to the previous recession. But this prominence, as Mohamed El-Erian, an economist, argues in his new book, "The Only Game in Town", was forced upon them by inaction elsewhere. "This was not a power grab," Mr El-Erian writes; central banks had to buy time until the political system got its act together—which by and large it didn't. Far too little effort went into economic policies to work with the grain of monetary easing, and thus to amplify its effects. Such policies would require governments to make decisions that they would rather duck, either with an eye to reforming the structure of the economy—and thus removing some entrenched privileges—or to increasing deficit spending.

If that remains the case, central bankers will have to reach yet further up their sleeves for radical new tricks with which to respond to the recession to come. But even if they do so, they will still require additional help—some of which, in a world of low interest rates, governments could more easily afford to offer. And if the problem runs deeper than a single recession—if, as Larry Summers, a Harvard economist, and others fear, rich nations are condemned to a long period of weak growth because of a persistent shortfall in demand—the need for bold new policies will become even greater.

Accentuate the negative

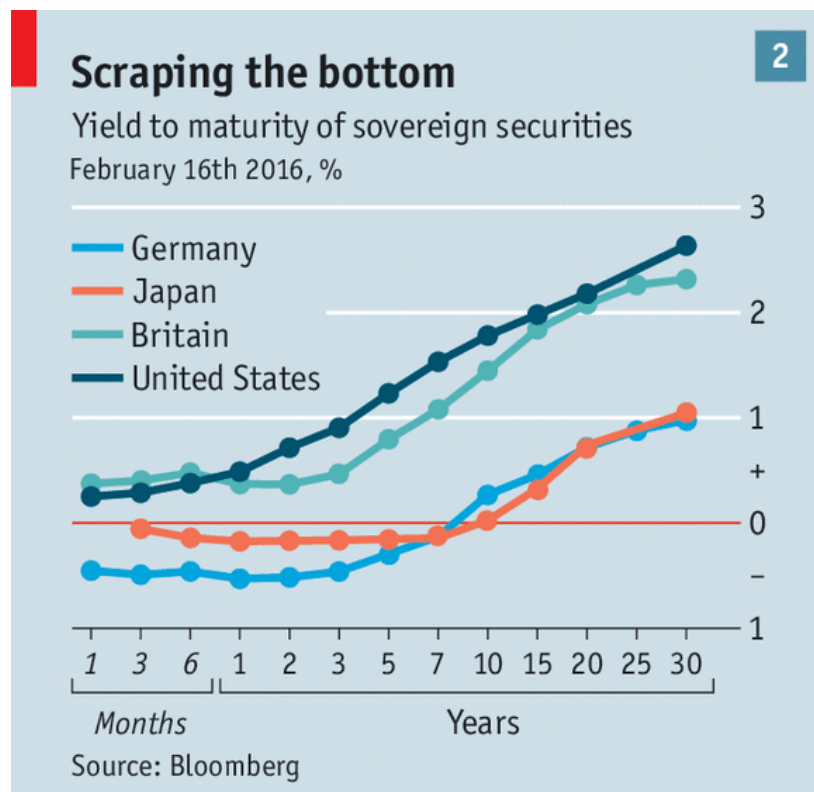
The menu of policy options comes in two parts. The first covers efforts to ensure that central-bank actions give their economies a bigger jolt. Second come well-targeted and flexible fiscal measures. Carefully chosen structural reforms can both complement such stimuli in the short term and sustain their good effects in

the longer term by helping the recovery sustain itself. All these measures can be given more oomph if they are co-ordinated with similar efforts in other countries.

Start with monetary policy. The scope for asset purchases by central banks is, in theory, unlimited. In a crisis such as that of 2008 the Federal Reserve can buy commercial paper issued by banks and companies or mortgage-backed securities. But it, or any central bank, could also buy an even broader range of assets, including high-yield bonds or stocks or even buildings, should financial markets go into free fall.

Textbooks will tell you that, because they create new money, such purchases will eventually give central banks the inflation rates they want. But the experience of QE since 2008 suggests that this is too slow a road to reflation to justify the way that it distorts asset prices and upsets currency markets. Critics of QE argue that its main effect has been to boost shares and to flood emerging markets with cheap money, driving a debt cycle the downward leg of which is now hurting rich-world economies.

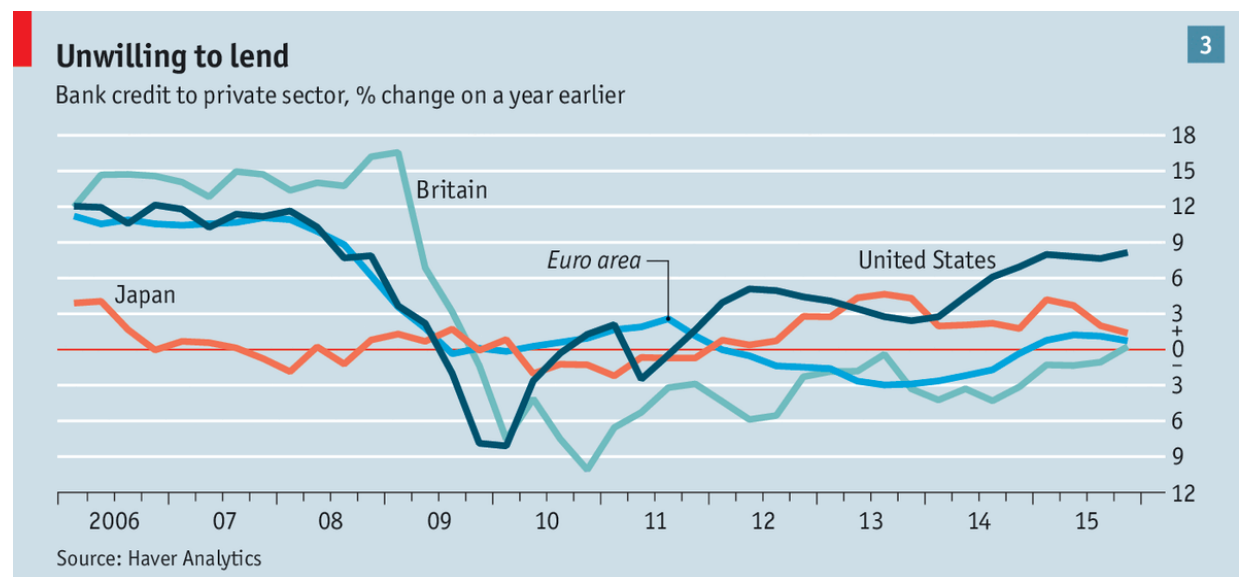
Perhaps other unconventional monetary policies might work better. Last month Japan's central bank joined its peers in Switzerland, Sweden, Denmark and the euro area by setting a negative interest rate—in Japan's case, levying a 0.1% charge on a portion of the reserves that commercial banks deposit with it. In Europe, where the lowest deposit rate set by central banks acts as a floor for interest rates in money markets, and thus for rates on loans more generally, the benchmark for borrowing rates has never been so low. In Germany government-bond yields have turned negative for terms of up to eight years (see chart 2).



Economist.com

Yet even if the boundary for interest rates is not zero, as people once tended to assume, it is not all that much less than zero. If interest rates were to go deep into negative terrain, depositors would switch to cash, which pays no interest but doesn't charge any either. And negative rates are not good for banks; deposit rates cannot be pushed down as hard as lending rates for fear that small savers might switch to cash, an effect which is squeezing bank profits in Europe. Such a squeeze hurts the banks' ability to rebuild the capital buffers that make them safe.

Since the existence of cash is a limit on how low interest rates can go, Andy Haldane, the chief economist of the Bank of England, and Ken Rogoff of Harvard University have proposed abolishing it altogether. But even if such radicalism were to prove feasible in a few countries, its effects might be limited. Savers would find alternative stores of value, such as precious metals or foreign banknotes, or pass on the cost of having money in the bank to others by making payments early.



Economist.com

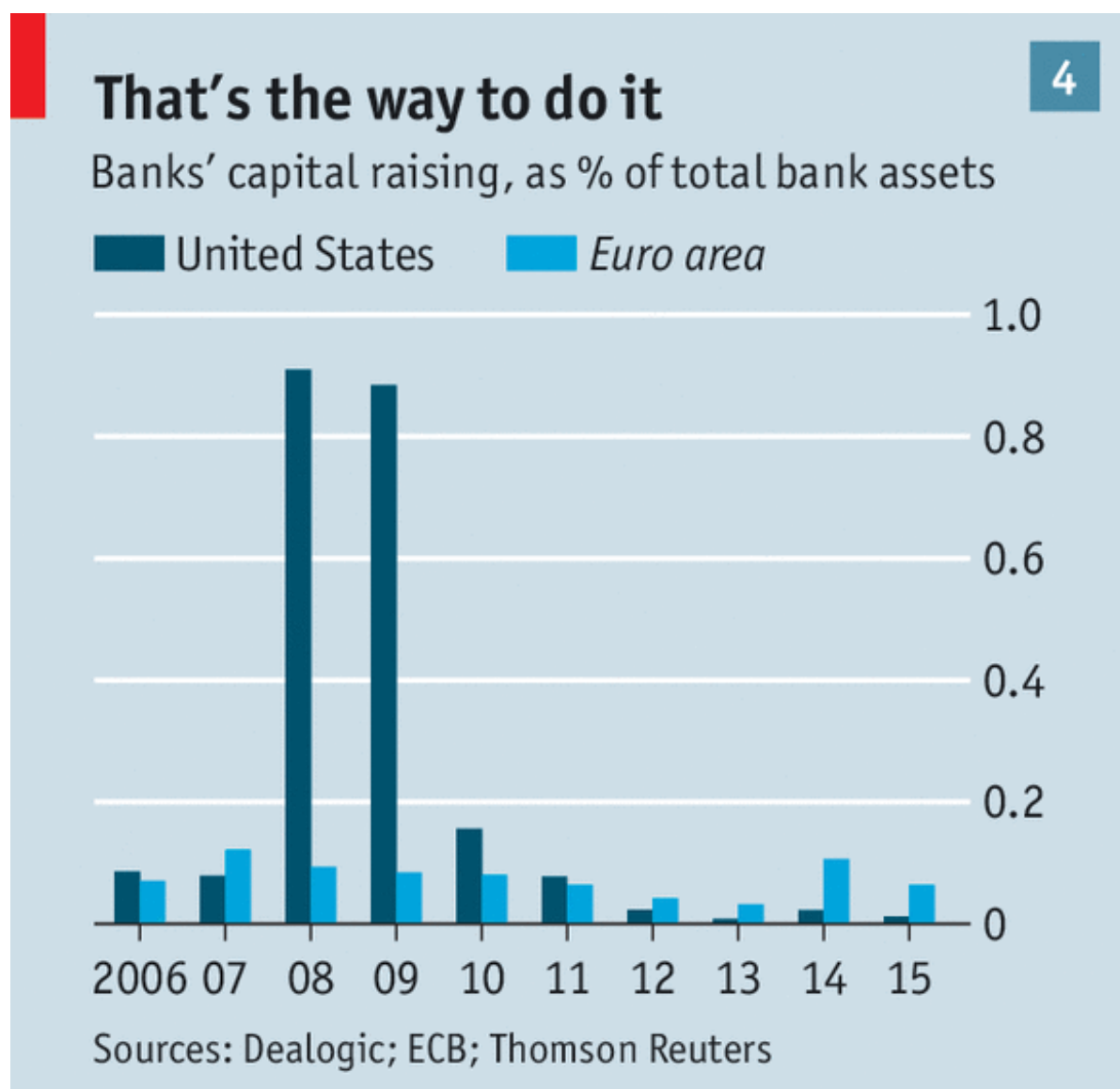
One reason central-bank policy has been less effective than the bankers would like is that low interest rates have not led to more borrowing and spending. Credit growth outside America has been feeble (see chart 3). The central banks have tried to deal with this. The Bank of England's funding for lending scheme of 2012 made the provision of cheap central-bank financing conditional on banks writing more loans to companies and householders. The European Central Bank (ECB) has come up with similar wheezes to try to induce banks to lend more freely. But their attempts have seen little success.

Bigging up the banks

As long as banks in the euro area face worries about their strength, they will be constrained in how much they can lend, no matter how cheap central-bank money is. Their record of raising fresh equity is worse than that of their counterparts in America and their profitability poorer, too. Despite this, capital has been allowed to leak from banks, notes Hyun Song Shin, head of research at the Bank for International Settlements, a clearing house for central banks. Most

European banks still pay some dividends and have not cut costs enough. This combination means that they struggle to build up more capital on their own.

American banks are performing better because in 2009 they were required either to raise capital for themselves or to have it forced upon them by government—in which case it would come with restrictions such as bonus caps for senior executives. This had a striking effect (see chart 4). Luigi Zingales, of the Chicago Booth School of Business, advocates a similar approach for the euro area. The European Stability Mechanism, an emergency euro-area fund, could be used to raise the money; the ECB could act as referee. An alternative is to free capital by taking bad loans off the banks' books, or by forcing banks to write their value down. But that would be messier, slower and—if governments overpaid for the bad loans—fall foul of European Union rules on state aid.



Economist.com

Healthier banks would be better able to supply loans; lower interest rates would make punters more willing to take them out. It is the essence of the current quandary that nominal interest rates can't go much lower than they already are.

But real rates could fall: all it takes is for borrowers to be persuaded that future inflation will be higher than they currently expect. Unfortunately, gauges of such expectations derived from bond prices—admittedly imperfect measures—are falling, not rising. The past two years have seen those expectations slump from 2.2% to 1.3% in America. One way to get them back up might be to set a higher inflation target. But when inflation sits so persistently below today's targets, persuading people that higher targets would produce higher rates will require action, not just words.

One way to raise expectations of inflation and boost aggregate demand is for a central bank and its finance ministry to collude in printing money to pay for public spending (or tax cuts). Such shenanigans are not possible in the euro zone, where the ECB is forbidden by treaty from buying government bonds directly. Elsewhere they might work as follows: the government announces a tax rebate and issues bonds to finance it, but instead of selling them to private investors swaps them for a deposit with the central bank. The central bank proceeds to cancel the bonds, and the government withdraws the money it has on deposit and gives it to citizens. "Helicopter money" of this sort—named in honour of a parable told by Milton Friedman, a famous economist—is as close as you can get to raining cash from a clear blue sky like manna from heaven, untouched by banks and financial markets.

Such largesse is, in effect, fiscal policy financed by money instead of bonds. It is conceivable that a bond-financed fiscal tax cut might in fact be cheaper to finance: although cash has a zero yield, medium-term bonds in Japan and in much of Europe have negative yields. But the unaccustomed drama—indeed, the apparent recklessness—of helicopter money could increase the expected inflation rate, encouraging taxpayers to spend rather than save. It is not something to rush into, or to try prophylactically; but in the midst of a global financial crisis, or a deep recession, it would have much to recommend it. If it were co-ordinated by a group of rich countries, all the better.

A related idea is to cancel a portion of the sovereign bonds purchased by central banks, ostensibly cutting public debt at a stroke. It would have the drawback, as would helicopter money, of leaving the central bank technically bankrupt, since its liabilities (money) would exceed its assets (bonds). But since most central banks are backed by national treasuries, this ought not to matter much. A bigger worry is that it is hard to know in advance what effect monetisation would have. Bond markets could panic about an inflationary surge, driving yields through the roof. Or they might just shrug the whole thing off. After all, the central bank could issue fresh bonds to soak up the excess money if things eventually got out of hand.

Not the only game in town

In places stuck in deflationary quicksand it may be necessary to be more radical still. Olivier Blanchard and Adam Posen of the Peterson Institute for International Economics have argued that Japan would benefit from an incomes policy. Under their proposal the state would mandate an across-the-board 5-10% increase in salaries in order to jump-start a spiral in which high wages drive up prices that drive up wages, thus soon leaving deflation behind.

Such a radical idea would meet stiff opposition. The Bank of Japan would have to allow for a temporarily higher inflation target. Bondholders would be very unhappy. But as Mr Blanchard and Mr Posen point out, years of deflation have enriched Japanese bondholders at the expense of the country's taxpayers. Putting the boot on the other foot for a while does not seem entirely unreasonable. In more open economies like America's, where companies face more overseas competition and bondholders are more likely to turn to other markets, the obstacles would be harder to surmount—supposing that the idea of the government raising wages could be stomached in the first place.

Those with memories of the dismal failure of incomes policies in the 1970s (aimed then at capping, rather than spurring, inflation) will be aghast that the idea might be considered at all. For one thing, employers back then often found ways to escape the mandate. Advocates argue that companies would be encouraged to meet the costs of the pay rises through higher prices—indeed that is the whole point. In the 1970s low real interest rates undermined the income policies' wage caps; today monetary policy and incomes policy would be pushing in the same direction.

The alternative to having treasuries and central banks working in ever more complex cahoots, or having governments fix pay rises, is to turn to the second part of the menu and deal with the shortfall in demand with straightforward fiscal policy. Increasing spending or cutting taxation is likely to be more effective than shaving interest rates a hair's-breadth more or having central banks buy more bonds. Loosening fiscal policy has drawbacks, though, both political and economic.

Fiscal policy is by its nature rather less fleet-footed than monetary policy: in normal times interest rates can be raised or lowered according to the ups and downs of the business cycle. Tax policy is a lot less flexible, but it can still be responsive, with changes introduced and reversed as needed. Spending plans are less easily changed. Once current spending on things like wages and pensions goes up, it is hard to cut; capital spending on public infrastructure requires planning, so is difficult to mobilise quickly.

Tax cuts are thus the better tool for boosting demand quickly. But they need to be carefully designed to maximise their impact. Income-tax cuts or increases in tax credits should be skewed towards those (typically the low-paid) who are more likely to spend them. In general, taxes should not overly influence decisions on what to buy or produce; better rely on the signals that the market provides. But in a recession, this principle might be suspended. It is discretionary spending that recessions hit hardest. So a temporary cut in the taxes on durable goods—cars, kitchens, televisions, and so on—can be expected to have greater impact on overall spending than a smaller cut in taxes on all goods, including necessities such as clothing and utilities.

At the same time as they tweak tax rates to stimulate the economy, governments would be well advised to overhaul the whole basis on which they are set. An ideal tax system has three aspects: it should be simple; it should be progressive, placing a greater burden on the rich; and it should not overly influence choices about how hard to work, what to produce or what to consume. Few rich-country

tax codes match up to this ideal. Getting them closer to it would help both boost economic growth and government finances in the long run.

All the bridges rusting

There are useful ways to increase current spending in a recession. Some countries, such as Denmark and Australia, run state-funded schemes to retrain those who have lost jobs and match them with available vacancies. Others might usefully follow their lead: “active labour-market policies” of this kind are all the more urgent in Europe, because of the influx of refugees from Syria. But the most effective fiscal boost comes from capital spending on new infrastructure or on the upkeep of that which is already there. Unlike tax cuts, which may be saved or spent on imports and thus have less effect on GDP, money sunk into roads, schools, hospitals and the like stays put. And capital spending induces complementary spending elsewhere in the economy more than any other intervention.

Despite the benefits of spending on public infrastructure, governments find it notoriously hard to deploy as an effective stimulus. For one thing, when public finances are under pressure during a recession the reflex response is to cut capital spending. For another, such cuts are sometimes quite good ideas: a lot of infrastructure spending is indeed wasteful. China has pristine highways that few wish to drive on. Alaska has bridges to nowhere. Governments tend to choose projects that make a political splash but have little underlying logic. That is in part why decades of capital spending in Japan have not done more to boost the economy.

Yet there is a painful need for more and better public infrastructure in a lot of countries, especially America. Mr Summers often gives the example of John F. Kennedy Airport, a rundown gateway to New York where the air-traffic control system is from another era. Last year a study by Trip, a transport think-tank, found that the potholed roads in 25 American cities were pushing up citizens’ annual car-maintenance costs by more than \$700 per vehicle. In 2013 a study by the American Society of Civil Engineers found that a third of America’s main roads were in a poor or mediocre state, and that one in nine of its bridges was not structurally sound.

In 2010 Barack Obama tried to move things along. He proposed a public infrastructure bank, to be staffed by technocrats who would appraise the costs and benefits of capital projects and put some money behind the ones they approved. The proposal failed to clear the Senate, which at the same time blocked a scheme to spend \$50 billion on improvements to roads, railways and airports. In principle a public-infrastructure bank has had bi-partisan support for decades. Hillary Clinton is only the latest of many politicians to back the idea. But all previous plans have foundered amid partisan squabbling.

An Australian initiative that combines infrastructure spending with privatisation shows promise. In 2013 New South Wales sold the ports of Botany and Kembla for A\$5 billion (\$5.3 billion), a handsome multiple of their earnings. The proceeds went to a state fund for reinvestment in other infrastructure. This model of “social privatisation” is a template for others to copy, says Brett Himbury, the boss of IFM, a big fund that invests in infrastructure assets on behalf of pension funds. The cash-strapped states that own airports in America

might usefully follow it to fund much-needed road repair. In private hands the condition of the airports would improve, too.

Make no small plans

Mr Himbury also has ideas on how to organise greenfield infrastructure projects. Involving private-sector partners in public infrastructure projects has often proved something of a sham. Rather than bringing hard-nosed business sense into the game, it can often both hide and escalate a scheme's true cost: think of the debacle of the upgrades to the London tube. But pension funds around the world are crying out for long-lived assets that will generate the inflation-linked income they have promised to those who retire. The specialist funds that manage these assets have expertise in appraising projects: they will often, for instance, take a more sober view than government officials on forecasts of traffic on a proposed toll road.

Mr Himbury suggests bringing these sources of patient capital in at the outset of a project to advise on its merits and to exert cost discipline on construction firms. The chosen builders should be rewarded for getting things right but should have deep enough pockets to pay the penalties when projects overrun. The private-capital partners in a project should agree on a range of returns and then share any extra profits or losses with government.

The precise choice of policies, and the degree of radicalism, will vary from country to country and according to the nature of the threat. A garden-variety recession in which output falls as existing stocks are run down would require a less drastic response than a bigger systemic shock, such as a Chinese hard landing. It would be wise for governments to work harder on improving public infrastructure or reforming taxes even in less uncertain times.

But the growing constraints on monetary policy mean that fiscal fixes and structural reforms that work with the grain of stimulus policies are more urgent than ever. Big and long-running programmes of public capital spending would give private firms greater confidence about future demand and make a sustained recovery more likely. Simpler tax codes would provide a sounder basis for the sort of shifts in tax rates that will be needed in future to counter the business cycle. Central banks have done their bit. Although more work from them will be vital, it is now time for governments to be bolder.