The next recession

Toxic politics and constrained central banks could make the next downturn hard to escape

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JUST a year ago the world was enjoying a synchronised economic acceleration. In 2017 growth rose in every big advanced economy except Britain, and in most emerging ones. Global trade was surging and America booming; China's slide into deflation had been quelled; even the euro zone was thriving. In 2018 the story is very different. This week stockmarkets tumbled across the globe as investors worried, for the second time this year, about slowing growth and the effects of tighter American monetary policy. Those fears are well-founded.

The world economy's problem in 2018 has been uneven momentum (see article). In America President Donald Trump's tax cuts have helped lift annualised quarterly growth above 4%. Unemployment is at its lowest since 1969. Yet the IMF thinks growth will slow this year in every other big advanced economy. And emerging markets are in trouble.

This divergence between America and the rest means divergent monetary policies, too. The Federal Reserve has raised interest rates eight times since December 2015. The European Central Bank (ECB) is still a long way from its first increase. In Japan rates are negative. China, the principal target of

Mr Trump's trade war, relaxed monetary policy this week in response to a weakening economy. When interest rates rise in America but nowhere else, the dollar strengthens. That makes it harder for emerging markets to repay their dollar debts. A rising greenback has already helped propel Argentina and Turkey into trouble; this week Pakistan asked the IMF for a bail-out (see article).

Emerging markets account for 59% of the world's output (measured by purchasing power), up from 43% just two decades ago, when the Asian financial crisis hit. Their problems could soon wash back onto America's shores, just as Uncle Sam's domestic boom starts to peter out. The rest of the world could be in a worse state by then, too, if Italy's budget difficulties do not abate or China suffers a sharp slowdown.

Cutting-room floors

The good news is that banking systems are more resilient than a decade ago, when the crisis struck. The chance of a downturn as severe as the one that struck then is low. Emerging markets are inflicting losses on investors, but in the main their real economies seem to be holding up. The trade war has yet to cause serious harm, even in China. If America's boom gives way to a shallow recession as fiscal stimulus diminishes and rates rise, that would not be unusual after a decade of growth.

Yet this is where the bad news comes in. As our special report this week sets out, the rich world in particular is ill-prepared to deal with even a mild recession. That is partly because the policy arsenal is still depleted from fighting the last downturn. In the past half-century, the Fed has typically cut interest rates by five or so percentage points in a downturn. Today it has less than half that room before it reaches zero; the euro zone and Japan have no room at all.

Policymakers have other options, of course. Central banks could use the now-familiar policy of quantitative easing (QE), the purchase of securities with newly created central-bank reserves. The efficacy of QE is debated, but if that does not work, they could try more radical, untested approaches, such as giving money directly to individuals. Governments can boost spending, too. Even countries with large debt burdens can benefit from fiscal stimulus during recessions.

The question is whether using these weapons is politically acceptable. Central banks will enter the next recession with balance-sheets that are already swollen by historical standards—the Fed's is worth 20% of GDP. Opponents of QE say that it distorts markets and inflates asset bubbles, among other things. No matter that these views are largely misguided; fresh bouts of QE would attract even closer scrutiny than last time. The constraints are particularly tight in the euro zone, where the ECB is limited to buying 33% of any country's public debt.

Spending ceilings

Fiscal stimulus would also attract political opposition, regardless of the economic arguments. The euro zone is again the most worrying case, if only because Germans and other northern Europeans fear that they will be left with unpaid debts if a country defaults. Its restrictions on borrowing are designed to restrain profligacy, but they also curb the potential for stimulus. America is more willing to spend, but it has recently increased its deficit to over 4% of GDP with the economy already running hot. If it needs to widen the deficit still further to counter a recession, expect a political fight.

Politics is an even greater obstacle to international action. Unprecedented cross-border co-operation was needed to fend off the crisis in 2008. But the rise of populists will complicate the task of working together. The Fed's swap lines with other central banks, which let them borrow dollars from America, might be a flashpoint. And falling currencies may feed trade tensions. This week Steve Mnuchin, the treasury secretary, warned China against "competitive devaluations". Mr Trump's belief in the harm caused by trade deficits is mistaken when growth is strong. But when demand is short, protectionism is a more tempting way to stimulate the economy.

Timely action could avert some of these dangers. Central banks could have new targets that make it harder to oppose action during and after a crisis. If they established a commitment ahead of time to make up lost ground when inflation undershoots or growth disappoints, expectations of a catch-up boom could provide an automatic stimulus in any downturn. Alternatively, raising the inflation target today could over time push up interest rates, giving more room for rate cuts. Future fiscal stimulus could be baked in now by increasing the potency of “automatic stabilisers”—spending on unemployment insurance, say, which goes up as economies sag. The euro zone could relax its fiscal rules to allow for more stimulus.

Pre-emptive action calls for initiative from politicians, which is conspicuously absent. This week’s market volatility suggests time could be short. The world should start preparing now for the next recession, while it still can.