Preventing a global slump must be the priority

By Martin Wolf

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Give credit where credit is due: Nouriel Roubini of New York University's Stern School of Business was right. On February 20 2008, I wrote a column entitled "America's economy risks the mother of all meltdowns", based on his analysis of the 12 steps to disaster. Alas, not only has the US taken those steps, but it has also – with help from others, including the UK – dragged the world behind it.

In a more recent note, Professor Roubini predicts a combination of stagnation and deflation*. In doing so he points, with some glee, to the most recent analysis of the global outlook from JPMorgan Chase, once among the most bullish of analysts. Now, under the rubric "A bad week in hell", JPMorgan states that: "Once again, we have taken an axe to near-term growth forecasts for the developed world and will likely follow up with additional downward revisions for emerging economies in the coming weeks. Already, our forecasts suggest that global gross domestic product will contract at a near 1 per cent annual rate" in the fourth quarter of 2008 and the first quarter of 2009.

JPMorgan expects shrinkage this quarter at an annualised rate of 4 per cent in the US, 3 per cent in the UK and 2 per cent in the eurozone. It is forecasting 0.4 per cent global growth in 2009, with advanced countries shrinking 0.5 per cent and emerging ones growing 4.2 per cent.

Given the near-disintegration of the western world's banking system, the flight to safe assets, the tightening of credit to the real economy, collapsing equity prices, turmoil on currency markets, continued steep declines in house prices, rapid withdrawal of funds from hedge funds and ongoing collapse of the so-called "shadow banking system", these forecasts even look quite optimistic. The outcome next year could be far worse.

If western governments had not intervened to guarantee and recapitalise banking systems, it would surely have been worse. Yet, as the charts show, even this has not halted the turmoil. Consider just two statistics: the capitalisation of world stock markets has halved; and, according to the Bank of England's latest Financial Stability Report, mark-to-market losses on vulnerable debt instruments now amount to a massive $2,800bn (€2,240bn, £1,790bn)**.

So what should be done? Some would argue: nothing at all. The view is widely held, particularly in the US, that the world needs a big purge of past excesses. Recessions, on this line of argument, are good. People who hold this view also argue that governments caused all the mistakes. The market would, they insist, be incapable of the errors we have seen. To them, Alan Greenspan's confession last week that "I made a mistake in presuming that the self-interest of organisations, specifically banks and others, was such that they were best capable of protecting their own shareholders" was about as welcome as Brutus's knife was to Caesar.

Intriguingly, the Bank's Financial Stability Report provides some support for this view: back in 1900, US banks had four times as much capital, relative to assets, as they do today. Similarly, the liquidity of the assets held by UK banks has collapsed over the past half-century. Implicit and explicit guarantees from governments have indeed made the financial system more dangerous than before. The combination of such guarantees with deregulation has proved lethal. Moral hazard is far from meaningless.

Yet the idea that a quick recession would purge the world of past excesses is ludicrous. The danger is, instead, of a slump, as a mountain of private debt – in the US, equal to three times GDP – topples over into mass bankruptcy. The downward spiral would begin with further decay of financial systems and proceed via pervasive mistrust, the vanishing of credit, closure of vast numbers of businesses, soaring unemployment, tumbling commodity prices, cascading declines in asset prices and soaring repossessions. Globalisation would spread the catastrophe everywhere.

Many of the victims would be innocent of past excesses, while many of the most guilty would retain their ill-gotten gains. This would be a recipe not for a revival of 19th-century laisser faire, but for xenophobia, nationalism and revolution. As it is, such outcomes are conceivable. Choosing to risk such an outcome would be like deciding to let a city burn in order to punish someone who smoked in bed. Risking huge damage now in the hope of lowering moral hazard later is mad.

Everything possible must be done to prevent the inescapable recession from turning into something worse. Many of the needed actions were laid out in an article on the FT's Comment page this week by Columbia University's Jeffrey Sachs. I would stress five points.

First, as Oxford university's John Muellbauer argues, deflation is a real danger***. Yet deflation is lethal for indebted economies. Today, short-term interest rates look far too high in the eurozone and the UK. Central banks need to look at their economies afresh and cut rates by at least 1, and ideally 2, percentage points.

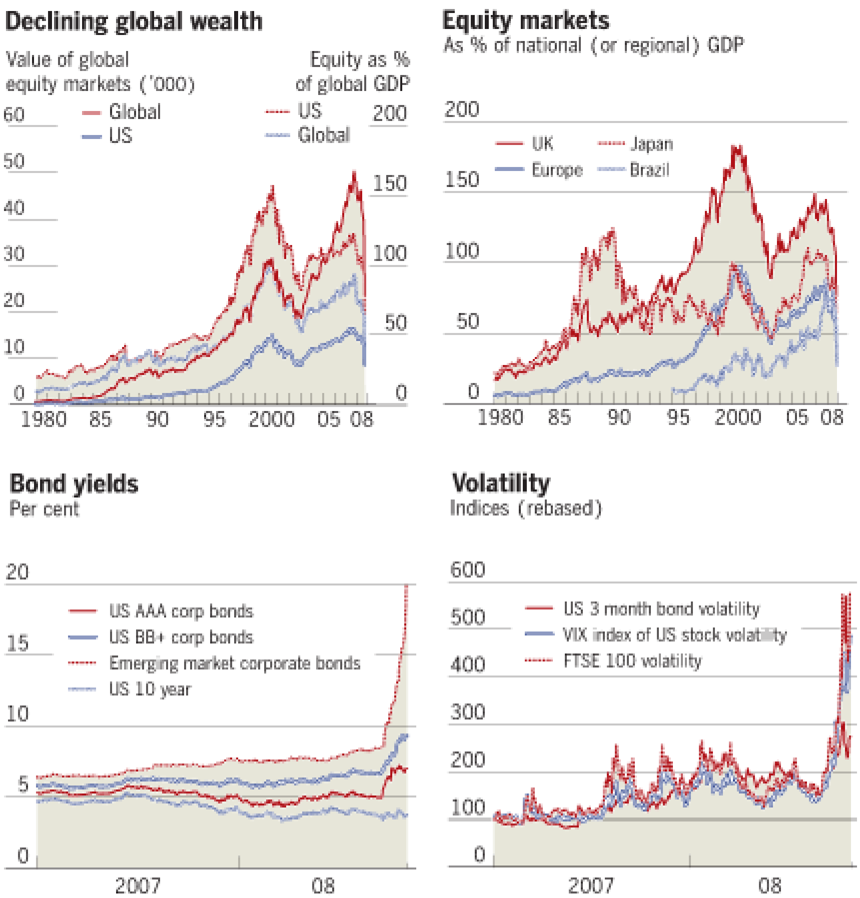
Second, the only way to let the private sector deleverage, without mass bankruptcy and huge falls in spending, is by substituting the asset everybody wants: government debt. Contrary to Professor Sachs, I think tax cuts are indeed part of the solution.

Third, it is crucial that lending be sustained both inside and among economies. Having gone to such trouble to recapitalise banks, governments should insist that their money be used to sustain credit lines to those likely to remain solvent. If banks are unwilling to do this, central banks will have to replace them, as the Federal Reserve is now doing.

Fourth, it is in the vital self-interest of the affected high-income countries to keep hard-hit emerging economies afloat through the crisis.

Finally, it is equally evident that the world will not return to equilibrium if countries in strong financial positions do not expand domestic demand. The day of the housing bubbles and huge current account deficits in high-spending high-income countries is gone. Those who rely on current account surpluses to sustain demand must think again.

Decisions made over the next few months may well shape the world for a generation. At stake could be the legitimacy of the open market economy itself. Those who view liquidation of past excesses as the solution fail to understand the risks. The same is true of those dreaming of new global orders. Let us first get through the crisis. The danger remains huge and time is short.



Sources: Thomson Datastream; IMF

** The Coming Global Stag-Deflation, October 25 2008, www.rgemonitor.com;** www.bankofengland.co.uk; *** The folly of the central banks of Europe, October 27 2008, www.voxeu.org*