Much ado about something

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At the beginning of 2016, a sense of unease and foreboding seemed to settle over all the world's major power centers. From Beijing to Washington, London to Brussels, Berlin to Brasilia, Moscow to Tokyo – governments, media and citizens were jumpy and embattled.

The prolonged turmoil in stocks, bonds, commodities (especially oil) and currencies, reflects investors' growing anxiety about global growth. And it reflects a general feeling of discomfort. The swirling forces are interconnected, so the volatility in one area can quickly spread to other countries and other markets. How much should forecasters and policymakers look to speculative markets as indicators of future prospects? And how alarmed should they be about the prospect of a global slowdown?

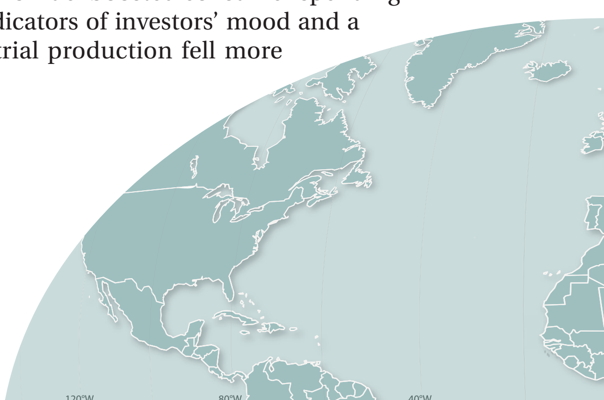
There is perhaps only one firsthand prediction that makes sense in human life: things take longer to happen than you think they will, and then they happen faster than you thought they could. Was Nouriel Roubini (a.k.a. Dr. Doom) right in December 2014 when he predicted that "the mother of all asset bubbles will burst in 2016"? Roubini understood that due to the low growth and low inflation in much of the world, there was liquidity leading to asset inflation: "All this liquidity is going to go into more asset inflation. So two years down the line, we could have this shakeout… 2016 I would say."

This kind of globalized anxiety is unusual. For the past 30 years and more there has been at least one world power that was bullishly optimistic. In the late 1980s the Japanese were still enjoying a decades-long boom – and confidently buying up assets all over the world. In the 1990s America basked in victory in the Cold War and a long economic expansion. In the early 2000s the European Union was in a buoyant mood, launching a single currency and nearly doubling its membership. And for most of the past decade, the growing political and economic power of China inspired respect all over the world. Yet at present all the big players seem uncertain, even fearful.

At first glance, however, things do not seem disastrous. According to Consensus Forecasts, global growth is expected to be 2.8% in 2016, up from 2.6% in 2015. Virtually all high-income economies have returned to growth. The eurozone economy is forecast to grow 1.7% in 2016, up from 1.5% in 2015. Britain's economy is forecast to grow by 2.3% and the US economy by 2.5%. Japan's is forecast to grow 1.2% in 2016, up from 0.6%. Asia (excluding Japan) is forecast to lead the world economy, once again, with growth of 5.7%. India's is expected to be the fastest-growing large economy in the world, with growth of 7.8% in 2016, against 6.9% per cent in China. Only Brazil and Russia among the big players are in recession: the former's growth is forecast at minus 2.2% in 2016, after minus 3.5% in 2015. Russia's growth is forecast at minus 0.2%, against drop of 3.8% in 2015.

This rather tolerable forecast hides important economic divergences and downside risks. The global economy still faces all manner of hazards, from the Greek saga to China's shaky markets. If any of these worries cause a downturn, the world will not be able to do much about it. Rarely have so many large economies been so ill-equipped to manage a recession, whatever its place of origin. Monetary policy is even more cramped. The Federal Reserve raised interest rates in December for the first time in nearly a decade. The Bank of England's base rate sits at 0.5%; and futures prices suggest that in early 2018 it will still be only around 1.5%. That is healthy compared with the euro area and Japan, where rates in 2018 are expected to remain stuck near zero. In other words, when central banks face their next recession, they risk having almost no room to boost their economies by cutting interest rates. That would make the next downturn even harder to escape. However, prominent economists, including Larry Summers, have argued that the economy still isn't strong enough to withstand higher interest rates. Raising rates while wages are flat and inflation is well below the central bankers' target risks pushing economies back to the brink of deflation and precipitating the very recession they seek to avoid.

The latest market declines came after the release of economic figures showing drops in December, even as tumbling prices for fuel boosted consumer spending power. Then indicators of investors' mood and a gauge of industrial production fell more



than economists had forecast. Larry Fink, BlackRock chief executive, warns markets may drop a further 10% after the global black Friday of January 15. “There is not enough blood on the streets,” he said.

Markets are more volatile than the fundamentals they seek to assess. Paul Samuelson quipped 50 years ago, “The stock market has predicted nine of the last five recessions.” While markets do sometimes send false alarms and should not be slavishly followed, conventional wisdom rarely recognizes gathering storms. Still, since markets are constantly assessing the future and aggregate the views of a huge number of participants, they often give valuable warning when conditions change. Policymakers who dismiss market moves as reflecting mere speculation often make a serious mistake. Markets understood the gravity of the 2008 crisis well before the Federal Reserve.

The Economist reports that looking across all major countries over the past several decades there were 220 instances in which a year of positive growth was followed by one of contraction. Few economies have ever gone as long as a decade without tipping into recession. Signals should be taken seriously when they are long lasting and coming from many markets, as with current market indications that inflation will not reach target levels within a decade in the United States, Europe or Japan. It is especially ominous when markets fail to rally on what should be good news. The core thing to be worried about is that you have an industrial world that is very short on demand.

It’s been six years since the last recession ended, so another one is possible. After all, the average post-World War II economic expansion lasted less than five years. And Murphy’s law – if something can go wrong, it will – decrees that, sooner or later, policymakers will face another downturn. However, over the past 70 years we’ve had an expansion that lasted 12 months and one that lasted 10 times that long. There’s no good way of knowing which end of the spectrum we’ll wind up on this time. It’s important to remember that another recession is bound to come eventually and that “eventually” could be sooner than many people think. But it’s not clear why this should mean a recession is more likely now than in, say, three or four years.

We need to seek fresh insights, because we’re entering a new phase in the evolution of the world economy. For the last five centuries the West was on the rise, culminating between the 1970s and 2008 in an age of continuing shake-ups all over the world, brought about by rapid economic, political and especially technological change. This was what came to be known as globalization: the open system of trade, information flows, and the spread of technology. But it was the West – and its liberal market-based democratic values – that drove global growth since the mid-20th century. At the end of the Cold War, around one billion people counted themselves in market economies. With the rise of emerging markets and the transition in India and China that number rose to between three billion and four billion people – a truly seismic shift.

The progressive abandonment of controls on capital, goods, services and labor – epitomized in this period by the creation of Europe’s single market and the birth of the euro – reached its apogee in the summer of 2007. At that point world financial flows had reached 14.7% of global GDP. Then, a new era was spurred by the 2008 global financial crash. The Great Recession happened at the same time as financial de-globalization, repatriation of capital and the rise of several cultures marked by unfamiliar, even antagonistic forms of non-Western modernity. Cross-border capital flows have fallen to 3.1% of global GDP, less than one quarter of their pre-crisis peak. The G-20 reflects the emerging economies’ (and cultures’) increasing weight. Yet these same countries, one time market favorites, face a period of prolonged and painful adjustment, especially those overly dependent on commodity cycles.

In short: we have moved from an era in which monetary policy was doing all the work to a post-crisis era in which the burden falls more on the politicians to take responsibility for structural reforms that will allow us to adapt to this seismic shift – and hopefully generate economic growth. Are they up to it? Having fought off the effects of the financial crisis, governments and central banks are understandably eager to get back to normal. The way to achieve their goal is to allow the recovery to gather strength first. The danger is that, having used up their arsenal, governments and central banks will not have the ammunition to fight the next recession. Indeed, so much ado may, in fact, be about something very real.