

Does the Future Lie Ahead?

It is a cliché that sometimes actually has been used by politicians – the future lies ahead, and, occasionally, its counterpart that the past is behind us. Just at the moment though, so great are the warnings of doom if we do not do exactly what certain politicians or special interest groups demand, that it seems possible to doubt if we have any future, or at least any reasonable one.

I think these alarms are overdone – at any rate for the long term; and I think the prescriptions being forced on us from all sides are sometimes sensible and sometimes distinctly not.

In this short end of year note I aim to lay out what I think the future holds over the next year or so, what policy proposals are sensible, and most important which are not.

How did we get here?

And, one might equally well ask, where is here? “Here” is apparently with a banking system in disrepair almost everywhere in the world – Spain being an interesting exception to that – and with economies expected to slow down rapidly, with inflation forecast to fall and to become for a time at least negative. How did this come about, and come about so suddenly?

That it came suddenly is important in understanding why it came. There can be no doubt over the suddenness, at least of the change in forecasts. In the UK for example, the consensus forecast (an average of a number of city, business, and academic forecasts) has swung from 2% real growth for 2009 at the beginning of 2008 to close to *minus 2%* now.

Experience is that such sudden changes come from problems in the banking sector. In the gold standard era there were occasional “Sudden stops and output drops”. These were invariably immediately preceded by a banking crisis. Such crises produce sharp monetary contractions, and also block a major channel by which funds flow from lenders to borrowers. These combine so as suddenly to constrict the economy.

The situation is actually very much like the first oil shock – something crucial to the workings of the world economy has suddenly stopped flowing.

So we look like going into a sharp recession. What produced the sudden contraction? The story is simple. We experienced unusually good times. The unusually good times were the consequence of central banks delivering by and large stable monetary policy. This was combined with low inflation and low interest rates thanks to the falling prices of manufactured goods coming from Brazil, China, and India, (among others). This led to an asset price boom and a search for yield. More risks were taken on, they worked out well, so more were taken on. Then the boom slowed, what looked like good assets suddenly were seen not to be, and a sharp banking contraction followed as banks swung from exuberance to prudence.

The story is not new, but it is new on this scale. Such problems have never in the past been so widespread. What should be done? Before answering that, it is useful to see what is being done in the major countries or groups affected: the USA, the UK, the

Eurozone and some of its more interesting members, the “BRICS”, and the interesting cases of Australia and Canada.

US response has lacked clarity and consistency

Here there is of course the policy confusion that always seems to occur in the gap between one President and another. Nevertheless, some sensible things are being done. Attention is focussed on the banking system and getting it functioning again. Policy has not been clear and consistent; it swung from buying assets from banks to recapitalising them, and, having done that, to buying assets again. This has been expensive in terms of funds promised and committed; but some of the funds will come back to the taxpayer, and it was better than the alternative of major banking system problems. For all the political unpopularity of bankers, the Great Depression has taught US policy makers the dangers of banking system failure.

So far they have also succeeded in resisting demands to bail out motor car manufacturers. Whether that will last is at the time of writing too early to tell.

The incoming administration has tremendous advantages. It can blame its predecessor for any unpopular but desirable actions – such as choosing not to raise taxes on middle incomes. And there have been two important and very good appointments. Larry Summers and Christina Romer have been given senior economic posts. Both are fine economists, and, particularly valuable, both have understood that many policies designed to alleviate the Great Depressions, such as tariffs and detailed intervention in industry, actually slowed recovery.

So sensible things have been done, and there is for the future hope of, at the least, resistance to folly. True, the US will have a big budget deficit, but the US economy can grow fast. The danger is that it is unwilling to wait for growth to deal with the deficit and tries a little inflation. The recent very aggressive easing will not cause inflation while the US is as depressed as it currently seems, but the need for equally aggressive tightening in the future if inflation is to be avoided has increased. Will the Fed have the courage to do it?

UK policy is in a mess

Here the news is not so good. Banks have been recapitalised. But what are they to do with the capital? Risk it or conserve it? The FSA is telling them to conserve, the Government screaming frantically that they should risk it by lending as before. There needs to be clarity from the banks’ big shareholder, not posturing.

Then there was an “emergency package” of tax cuts and spending increases. A waste. The funds could have been used to provide insurance to banks against capital loss. They would then have started to lend, even given the current uncertain value of many assets they hold. The recent interview with Bank of England Deputy Governor Charles Bean showed that he understands what really should be done. But as taxpayers’ money is required to do it, action can come only from the Government.

Instead we had increased public spending, and temporary tax cuts.

As David Ricardo pointed out in 1823, temporary tax cuts financed by bond sales will have a trivial effect on spending; people will just save against the higher taxes to

come. The fiscal stimulus will not stimulate, and it risks leaving the UK with a still larger public sector, and the consequent effects on growth. There is a chance we could in five years or so have a slow growing heavily indebted and highly taxed economy. The only preventative will be substantial cuts in the public sector by whatever government wins the next election. It could well be one of these elections that a strictly self - interested politician would prefer to lose, but not by much. No doubt there are some who would say that is the present government's aspiration.

Eurozone is under unprecedented strain

Is there a Eurozone any more? They still have a single currency, but in every other aspect it is every country for itself. That is a good thing. The German finance minister, with his pointed comments on British policy, is not only commenting sensibly on Britain but reminding people that not every country starts from the same situation. The starting point – how much debt you have, for example – is important. But there are grounds for concern over the very same self interest.

What will happen when countries get into fiscal difficulties? Consider Ireland. It has offered enormous amounts of support, in the form of guarantees, to its banks. If these are called could Ireland pay? Is it really another Iceland? It could borrow to meet the obligations, and it does start from a low debt to income ratio; but how much appetite is there for Irish government debt? If there were problems, would other Eurozone countries help out? It is hard to see Germany doing so; if there is no case for fiscal support at home, they will not burden their citizens with the costs of fiscal support for another country.

Greece is an even more dramatic case. It is close to ungovernable. The opposition is fomenting riots. What do they imagine will happen should they gain office? Is there a Greek government to give financial support to, even if there were the willingness to give it? (The Italian fiscal problem is so chronic that it has been pushed from the headlines by newer bad news, but it should nevertheless not be forgotten.)

The Euro is going through a dangerous time. That clouds prospects for all Eurozone members.

Nevertheless, prospects there are better than in the UK. Not only are financial sectors in every large Eurozone member relatively smaller than in the UK, but they have by and large been more conservative. And although the debt to income ratio of the UK is not too bad on the published figures, it does have a problem of which the large Eurozone members are free. The government was borrowing even at the peak of a boom. Greater fiscal adjustment is need in the UK than in any major Eurozone member.

This problem might be offset by the helpful effect of weakening sterling, except that Britain's main customers are themselves not prosperous, so there will be little boost to Britain's exports.

BRICS' economies don't present a uniform picture

BRICS is a catchy but misleading term. They are different in very important ways. Brazil and India are functioning democracies with the rule of law having a major part in commercial life. That is important for economic growth, and helps maintain stability at times of economic stress. Their growth rates will undoubtedly slow, but

then they will recover. India will recover from the recent terrible events. The slowdown in Brazil and India will not be to such low levels as in the West, for they are still developing, still “Catching Up” with the developed economies. Their sustainable growth rate is still high, so even if they slow to it they will grow faster than the West.

China is fascinating. It is the only example of a country experiencing sustained economic growth without first establishing secure private property rights. Will the slowdown suddenly reveal this as a flaw, or will it be an opportunity for orderly economic relationships to emerge? Will it, indeed, encourage the emergence of the rule of law? Because there will be fewer spoils to share, will people be more concerned to get what they were promised? There are long run uncertainties about China. This period of slower growth may lead to the reduction of these.

And finally, Russia. That country can very reasonably be described as an oil and gas producer with an ageing population and nuclear weapons, and run by an unstable oligarchy with aspirations to perpetuate itself. Problems could be bought off when oil prices are high. Will it attempt to buy off internal pressures by foreign adventures when oil prices are low?

Two countries stand out as relative safe havens: Australia and Canada

These two countries are almost completely uninteresting in the best possible way, because they avoided mistakes in the boom. Canadian bankers were, as is their custom, cautious; and even if Australian bankers had wanted to take big risks they had a very effective regulator. Meanwhile, the governments of Australia and Canada had the sense to display fiscal prudence, and repaid debt in the good times. Add to that that both are major mineral producers, and it becomes clear that the prospects there are good. There is little bad news to get excited about.

It's the supply, stupid

In two of the BRICS, China and Russia, political issues will be brought to view by the economic stresses of the slowdown in the West spreading to them. Otherwise, the outlook for the BRICS is pretty clear. It is in the West that there are major economic uncertainties. The Eurozone is under unprecedented strain. That individual countries are acting according to their own situation is at the moment good; but if the system comes under stress both how the members will react and what the consequences will be is a mystery. The US economy may well recover readily from the problems originating in banking system strains; policy there, like all policy, is not perfect, but it is on the right lines. In Britain policy is in a mess. Money has been wasted on pointless fiscal expansion when it could have been much more useful in encouraging the banking system to recover.

This where we come back to the comparison with the first oil crisis. As then, a major resource that the economy needs has been cut off. Then as now the countries which will come relatively well out of the situation will be the ones which deal with that restriction of supply, trying to get supply flowing again. Those which attempt to deal with a supply shock by boosting demand are simply deferring problems – and perhaps not for too long.

Geoffrey Wood, 15 December 2008