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Struggling with a great contraction

By Martin Wolf

What has the market turmoil of August been telling us? The answer, I suggest, is three big things: first, the debt-encumbered economies of the high-income countries remain extremely fragile; second, investors have next to no confidence in the ability of policymakers to resolve the difficulties; and, third, in a time of high anxiety, investors prefer what are seen as the least risky assets, namely, the bonds of the most highly rated governments, regardless of their defects, together with gold. Those who fear deflation buy bonds; those who fear inflation buy gold; those who cannot decide buy both. But few investors or corporate managers wish to take on any longer-term investment risks.

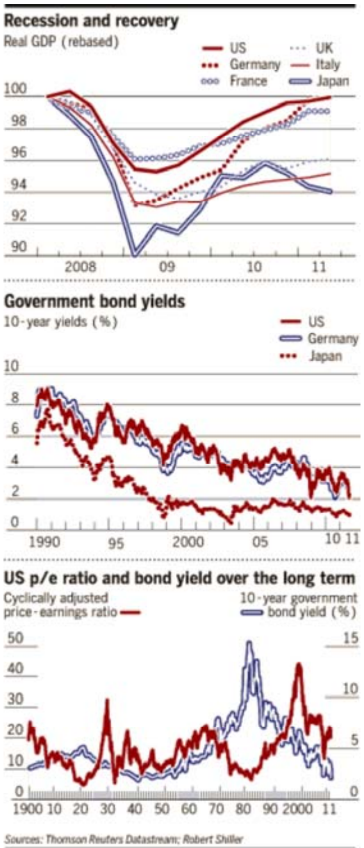
Welcome, then, to what Carmen Reinhart, senior fellow at the Peterson Institute for International Economics in Washington, and Harvard's Kenneth Rogoff call "the second great contraction" (the Great Depression of the 1930s being the first). Those less apocalyptic might call it the "Japanese disease".

Many ask whether high-income countries are at risk of a "double dip" recession. My answer is: no, because the first one did not end. The question is, rather, how much deeper and longer this recession or "contraction" might become. The point is that, by the second quarter of 2011, none of the six largest high-income economies had surpassed output levels reached before the crisis hit, in 2008 (see chart). The US and Germany are close to their starting points, with France a little way behind. The UK, Italy and Japan are languishing far behind.

The authoritative National Bureau of Economic Research of the US does define a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months". This is to focus on the change in output, rather than its level. Normally, that makes sense. But this recession is not normal. When economies suffer such steep collapses, as they did during the worst of the crisis (the peak to trough fall in gross domestic product having varied between 3.9 per cent in France and 9.9 per cent in Japan), an expansion that fails to return output to the starting point will not feel like recovery. This is especially true if unemployment remains high, employment low and spare capacity elevated. In the US, unemployment is still double its pre-crisis rates.

The depth of the contraction and the weakness of the recovery are both result and cause of the ongoing economic fragility. They are a result, because excessive private sector debt interacts with weak asset prices, particularly of housing, to depress demand. They are a cause, because the weaker is the expected growth in demand, the smaller is the desire of companies to invest and the more subdued is the impulse to lend. This, then, is an economy that fails to achieve "escape velocity" and so is in danger of falling back to earth.

Now consider, against this background of continuing fragility, how people view the political scene. In neither the US nor the eurozone, does the politician supposedly in charge – Barack Obama, the US president, and Angela Merkel, Germany's chancellor – appear to be much more than a bystander of unfolding events, as my colleague, Philip Stephens, recently noted. Both are – and, to a degree, operate as – outsiders. Mr Obama wishes to be president of a country that does not exist. In his fantasy US, politicians bury differences in bipartisan harmony. In fact, he faces an opposition that would prefer their country to fail than their president to succeed. Ms Merkel, similarly, seeks a non-existent middle way between the German desire for its partners to abide by its disciplines and their inability to do any such thing. The realisation that neither the US nor the eurozone can create conditions for a speedy



restoration of growth – indeed the paralysing disagreements over what those conditions might be – is scary.

This leads us to the third big point: the dire consequences of soaring risk aversion, against the background of such economic fragility. In the long journey to becoming ever more like Japan, the yields on 10-year US and German government bonds are now down to where Japan's had fallen in October 1997, at close to 2 per cent (see chart). Does deflation lie ahead in these countries, too? One big recession could surely bring about just that. That seems to me to be a more plausible danger than the hyperinflation that those fixated on fiscal deficits and central bank balance sheet find so terrifying.

A shock caused by a huge fight over fiscal policy – the debate over the terms on which to raise the debt ceiling – has caused a run into, not out of, US government bonds. This is not surprising for two reasons: first, these are always the first port in a storm; second, the result will be a sharp tightening of fiscal policy. Investors guess that the outcome will be a still weaker economy, given the enfeebled state of the private sector. Again, in a still weaker eurozone, investors have run into the safe haven of German government bonds.

Meanwhile, stock markets have taken a battering. Yet it is hard to argue that they have reached a point of capitulation. According to Yale's Robert Shiller, the cyclically adjusted price-earnings ratio for the US (based on the S&P 500) is almost a quarter above its long-term average. In 1982, the valuation was a third of current levels. Will markets avoid such a collapse? That must depend on when and how the great contraction ends.

Nouriel Roubini, also known as "Dr Doom", predicts a downturn. "A stopped clock", some will mutter. Yet he is surely right that the buffers have mostly gone: interest rates are low, fiscal deficits are huge and the eurozone is stressed. The risks of a vicious spiral from bad fundamentals to policy mistakes, a panic and back to bad fundamentals are large, with further economic contraction ahead.

Yet all is not lost. In particular, the US and German governments retain substantial fiscal room for manoeuvre – and should use it. But, alas, governments that can spend more will not and those who want to spend more now cannot. Again, the central banks have not used up their ammunition. They too should dare to use it. Much more could also be done to hasten deleveraging of the private sector and strengthen the financial system. Another downturn now would surely be a disaster. The key, surely, is not to approach a situation as dangerous as this one within the boundaries of conventional thinking.

What being bolder might mean and what should therefore be done will be the topic for next week's column.