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No need for double dip

Economic View

Will there be a double-dip recession? Suddenly, this question seems everywhere, not least in the proverbial taxi drivers' conversations and magazine covers that are often reliable "contrary indicators" of a trend in conventional wisdom that is about to turn. What makes the sudden return of universal pessimism this summer even more suspicious is the bewildering variety of reasons cited for the gloom.

Most people in Britain are anxious about savage public spending cuts causing another economic downturn. But international business publications have very different worries. "Will America drag the world into recession?" moaned the front-page of Saturday's *Financial Times*. Meanwhile, *The Economist*'s cover showed a drooping Eiffel Tower with a similarly despairing caption: "Can anything perk up Europe?" Others complained about the slump in Japan, the bursting property bubble in China and so on.

Strangely, nobody seemed to blame the one phenomenon that is most relevant when financial sentiment abruptly changes, as it has in the past two months: the fact that markets go up and down, not necessarily in that order.

Short-term market movements are mostly driven by so-called technical factors — chart patterns, psychological resistance and support levels such as 10,000 on the Dow Jones average, 5,000 on the FTSE 100 or $1.50 on sterling. These short-term gyrations have nothing to do with the economic and political fundamentals that City analysts, taxi drivers and central bankers talk about. Once important technical levels are breached, however, analysts come up with a multitude of explanations to rationalise what the markets, in their wisdom or their stupidity, have done. Such ex-post thinking is the likeliest explanation of the present bout of nerves afflicting the world economy.

There are, however, three genuine reasons for concern, as there have been throughout the economic recovery that began in spring 2009, when governments and central banks all over the world realised that printing money without limit would be the only way to avoid a repetition of the 1930s.

Expectations of a decent economic recovery after Lehman always rested primarily on the assumption that relaxation of monetary policy — near-zero interest rates plus a willingness to print money without limit plus unconditional guarantees that no significant banks anywhere in the world would be allowed to fail — would compensate first for the short-term paralysis in the financial system and then for the long-term necessity to reduce public debts.

The first risk to this assumption was the possibility of another Lehman-style financial meltdown, this time in the eurozone. This risk, however, was notably diminished on the historic weekend of May 8-10, when EU leaders effectively tore up the no-bailout clause of the Maastricht treaty and began the process of creating a European fiscal union to match the monetary union.

The second risk was that governments would act so aggressively to slash spending and raise taxes that even ultra-stimulative monetary policies of zero-interest rates and massive quantitative easing would be insufficient to maintain private spending and investment. This danger has certainly increased recently in Britain, where the Treasury seems insouciant to the point of irresponsibility about cutting spending too rapidly in the next year or two.

> **A return to recession due to overaggressive fiscal tightening is very unlikely**

At the same time, the Government has deliberately avoided addressing the genuine threats to Britain's long-term fiscal solvency, which stem entirely from the extravagant health and pension benefits created by successive governments as bribes to elderly voters.

In other big economies, however, the plans for fiscal tightening are much more reasonable than in Britain. Germany, for example, plans to reduce its deficit by only 2.5 per cent of GDP between 2010 and 2013 — about one third the debt reduction George Osborne wants to see in Britain. It seems alarmist to suggest, therefore, that the whole world is threatened by overzealous fiscal tightening, although this may be true of Britain.

For the world as a whole a double dip due to overaggressive fiscal tightening is very unlikely, unless there is a failure of monetary policy, too. If central banks see private demand flagging in the face of fiscal retrenchment, they still have powerful tools at their disposal to stimulate growth and employment. Just because short-term interest rates are near-zero bound, this does not mean that monetary policy has run out of ammunition. If governments drastically tighten fiscal policy, central banks can and, in my view, should push long-term interest rates on bonds and fixed-rate mortgages close to zero, too. Once businesses and homeowners realise that near-zero interest rates are not just a temporary aberration, but a long-term feature of the post-crisis economy, their eagerness to pay off debts will be replaced by a newfound willingness to invest in new equipment, buy homes and spend.

Central bankers gained independence from politicians in the 1990s because they were successful in managing inflation and economic growth. If they now refuse to take the obvious steps necessary to avert a double-dip recession, central banks will have their independence taken away from them — and rightly so.