

After the crisis, prepare for four aftershocks

The combination of the tsunami, oil prices, European debt and conflicting monetary policy could prove deadly

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As Shakespeare wrote in *Hamlet*: "When sorrows come, they come not single spies but in battalions." Just when it seemed the worst was over after the 2008 financial disaster, the world economy is suddenly confronted with four even greater risks.

The horrors understandably dominating the headlines have been the Japanese tsunami and the Libyan civil war. But two other risks, potentially as serious in their economic impact, if not in their human toll, have suddenly arisen in Europe. First is the impending conflict between European and US economic policy. The European Central Bank's announcement of a plan to raise interest rates two weeks ago was accentuated by yesterday's statement from the Federal Reserve Board, which suggested again that the US would take the opposite course if the oil shock or Japanese tsunami threatened to weaken the US economy.

This monetary conflict points to another potential disaster: a Lehman-style meltdown in the European banking system caused by

the lethal combination of monetary tightening and the unconvincing response to the eurozone's debt crisis.

What makes all these risks particularly frightening at present is that the world economy is still in a state of convalescence after the 2008-09 crisis and may be too weak to withstand any one of these shocks, never mind all four hitting together.

With unemployment still at crisis levels and wages falling in real terms in much of the world, with banks still struggling to rebuild their capital after the sub-prime debacle and with government deficits out of control, the world economy is unusually vulnerable to the loss of economic activity resulting from the Japanese devastation, even if this lasts just a few

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weeks or months. As the Lehman crisis demonstrated, even a brief breakdown in world trade and global supply chains can cast a shadow over the world economy for years ahead.

To make matters worse, a mutually reinforcing interaction between the Middle Eastern oil shock, the Japanese nuclear meltdown, the European sovereign debt crisis and the transatlantic conflict of monetary policy could damage the structural underpinnings of the global economy.

The resurgence of anti-nuclear

hysteria among politicians and so-called environmentalists, especially in Europe, could now sabotage efforts to wean the world off fossil fuels. If nuclear programmes are suspended, as they were in Germany this week, then the world's dependence on fossil fuels is bound to increase and carbon limits are bound to be abandoned, since nuclear power is the only alternative that can plausibly replace coal and oil for large-scale electricity generation in the next 20 years.

If fossil fuels displace nuclear power in electricity generation, instead of the other way round, the damage to the world economy will be profound. The environmental arguments for converting transport systems from petrol to electricity will be negated, removing one of the most promising sources of investment and innovation in the coming decades. At the same time, the price of oil will be further boosted, along with the power of Middle Eastern despots.

An even greater long-term risk to the world economy arises from the backlash against globalisation if a second global recession came hot on the heels of the "great recession" of 2008-09. Voters all over the world have lost jobs, homes and pensions as a consequence of dimly understood events on the other side of the globe. Imagine the populist reaction if this "first crisis of globalisation", as Gordon Brown called it, were to be followed almost immediately by another wave of job losses, bankruptcies and property collapses.

People who suddenly discover their

vulnerability to uncontrollable events half a world away are likely to respond by turning inwards. This is now happening even within Europe, where the clumsy and myopic response of governments and central bankers to the banking and sovereign debt crises has convinced German and Dutch voters that their economic hardships are caused by the Greeks and the Irish — and vice versa.

On the face of it, reverting to economic policies of national

Xenophobia could become unstoppable in a second recession

self-reliance might well seem the logical response to a global system that seems so unstable. It is a position that considers only the jobs lost to imports and the chaos caused by occasional financial crises, while ignoring the jobs, businesses, wealth and consumer goods created by burgeoning world trade.

While a highly interdependent global economy is more susceptible to disruption than a simpler one where each nation produces everything it consumes, it is also far more efficient and innovative. To pull out from the global economy because it is vulnerable to disruption is like disengaging from the internet because it is too complex and vulnerable to failure.

Nevertheless, the xenophobic politics of self-reliance has already

gained ground after the Lehman crisis, as evidenced by the rise of ultra-nationalist parties in the Netherlands, Germany, France and Sweden, by the anti-immigrant sentiment in Britain and by the isolationism of the Tea Party in the US. These movements would probably become unstoppable if a second recession were now triggered by global events beyond the control of any nation or international institution.

Now for the good news. It is still perfectly possible for leaders to limit the risks to the global economy. The US and Europe could act to reduce oil prices by releasing their petroleum reserves and by banning trading in energy derivatives all too reminiscent of the toxic assets that caused the mortgage crisis. They could raise taxes on fossil fuels and support economic activity by channelling the resulting revenues directly into tax cuts on incomes and consumption. They could reaffirm their commitments to nuclear power and accelerate investment programmes to replace ageing reactors with safer, more modern designs.

They could also instruct their central banks not to raise interest rates and announce their readiness to suspend or reverse public spending cuts if the global economy slows down.

The world today certainly faces a "battalion of sorrows" but, like Hamlet, international leaders have a choice. They can do nothing and accept fatalistically that the world economy could go to hell. Or they can "take arms against a sea of troubles and by opposing end them".