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It's not the € or US debt. It's worse than that

Anatole Kaletsky

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The world must work together to stave off a new recession. The trouble is we've run out of weapons to fight it

What are the causes of the latest financial market meltdown and what does it mean? As usual in economics, there are many answers, but the two mentioned in most headlines — the crisis in the eurozone and America's loss of its triple-A credit status — are almost certainly wrong.

The decision by Standard & Poor's to reduce US credit to AA+ could become a nightmare for Barack Obama, the first president to suffer the humiliation of a credit downgrade in US history. Or voters could blame the Republican-controlled Congress.

After the confrontation over government debt last week the proportion of voters supporting the Tea Party fell from a peak of almost 40 per cent late last year to 18 per cent — roughly the same as the 24 per cent of Republicans and 14 per cent of all voters who tell pollsters that Mr Obama "may be the Antichrist".

Whatever the political implications, for professional investors the credit downgrade was nothing more than a feeble joke. The so-called rating agencies — really just commercial businesses — disgraced themselves with the conflicts of interest that were revealed in the sub-prime mortgage crisis when they charged hundreds of millions of dollars for providing triple-A ratings on securities that almost immediately went bust.

As a result, their pronouncements no longer have any real influence on markets. This was confirmed on Monday when the US Treasury enjoyed a cut in the interest that it has to pay on its borrowings immediately after the downgrade. This apparently perverse behaviour came as no surprise to sophisticated investors, who have long made money by doing the opposite of what the agencies suggest, for example, lending money at lower interest rates to Japan every time its status was downgraded by S&P.

In short, whatever caused the market panic, it was not angst about Washington's credit rating. How about the crisis in the eurozone and its spread from Greece, Ireland and Portugal to Italy and Spain?

A break-up of the euro would be a terrifying upheaval for the world economy, but the European Central Bank's decision on Sunday to start buying the bonds of the Italian and Spanish governments has won a reprieve at least until the autumn. Then Europe's politicians must face the inevitable decision that they have postponed since the start of the crisis: to dismantle the euro or to create a full-scale fiscal federation. And the Italian and Spanish bond markets responded positively to the ECB initiative, enjoying gains on Monday and stabilising yesterday.

If we eliminate these causes, are we left with irrational herd behaviour? Nice as it would be to dismiss this week's mayhem as panic, there are at least three serious reasons for the sudden outbreak of pessimism.

The most important was the huge downward revision to US economic statistics revealed at the end of July. Until then the US economy was generally believed to have enjoyed quite a strong rebound after the Lehman crisis, with only employment lagging behind previous recoveries. But with the more detailed information now available, all the way back to 2003, it is apparent that the US economy has been much weaker throughout the past decade and that the post-Lehman recession was much deeper than previously believed.

It now appears that the US economy has not yet recovered the ground lost in the recession — and, worse still, that the recovery in the first half of this year fizzled out to an annualised rate of only 0.8 per cent. The upshot was that America had very little momentum going into the third and fourth quarters. Suddenly the self-sustaining growth expected by most US businesses and investors, by the Federal Reserve Board and by many analysts (including me) was cast into grave doubt.

It is now much more likely than it seemed just a few days ago that the US will suffer a double-dip recession or a long period of Japanese-style stagnation — in other words, a fate very similar to that facing Britain. This was confirmed by the grim industrial production and housing statistics for the UK published yesterday, not to mention the economic disruption and despair caused by this week's riots.

The possibility, if not yet the likelihood, that the US might sink back into recession points to a second genuine cause for alarm. This is the sense that governments and central banks all over the world have run out of policies to revive growth. The US Government and the Fed appear to have no plausible options. Additional fiscal stimulus is ruled out by record deficits and political stalemate, while the Fed's efforts to stimulate the economy by printing money seem to have failed so far.

More money printing was immediately demanded by many investors suffering losses on Wall Street. But another dose of quantitative easing could prove dangerously counter-productive if it pushes up oil and food prices and undermines the dollar, as it did after the previous round of QE last autumn.

In theory, the US Government could try plenty of other policies — for example, infrastructure investment financed by asset sales or financing by the Fed to prevent foreclosed houses undermining property prices — but in practice such overt intervention seems impossible, given the political mood in Washington today.

The paralysis in Washington leaves one other possibility for promoting recovery — a shift to more growth-promoting policies in Europe, Japan and other leading economies. Sadly, this prospect also suffered a serious setback last week.

The ECB failed to reverse the premature interest rate increases announced in March, which have already begun to damage growth. Britain remains stuck in economic limbo and China spent last week denouncing the irresponsible US and European policies, instead of proposing anything constructive itself.

Only Japan and Switzerland tried to do something last week to stabilise the financial markets, by acting to weaken their currencies and support the dollar. For such efforts to work, however, would require a degree of global co-operation that is notably absent.

And without any such international co-operation, the world will just have to hope that business and consumer confidence revive of their own accord. Sooner or later, the private sector will recover and generate some kind of economic revival. But it will be a long and painful wait if governments and central banks around the world cannot co-operate to avert another recession.