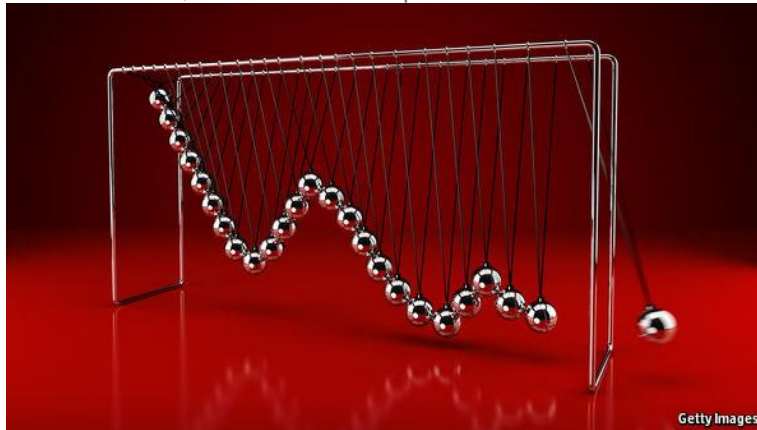


Doom and gloom

Do falling markets mean recession is on the horizon?

The Economist

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MARKETS have begun the year in extremely wobbly fashion. Plunging equities have generated most of the headlines; major indexes in Asia and Europe are now in bear market territory, meaning that they have fallen more than 20%. But fear is visible in other places as well. Commodity prices are sinking. Safe-haven currencies and bond prices are soaring, while shakier ones are getting smoked.

Crashing markets certainly seem like cause for concern, and the dreaded r-word is popping up with increasing frequency in tweets and blog posts and news stories. But is it really possible that recession lurks ahead? Manufacturing activity looks weak in many countries, but the high-frequency data in most of the rich world, and certainly in America and Europe, does not at all suggest that a slowdown is underway. Many of the world's prominent economists have declared that the market swoon looks out of step with fundamentals. On January 19th Maurice Obstfeld, the chief economist at the IMF, said that markets appeared to be overreacting to "small bits of evidence". And indeed, updated IMF forecasts released this week predict growth in 2016 across all the big rich economies. Of course, the IMF's track record in this regard is not the best. *The Economist* recently analyzed all of the IMF's country forecasts going back to 1999.

Over the period, there were 220 instances in which an economy grew in one year before shrinking in the next. In its April forecasts the IMF never once foresaw the contraction looming in the next year. Even in October of the year in question, the IMF predicted that a recession had begun only half the time.

Recessions are often difficult to spot until they have already begun. Still, there are usually some indications of a slowdown before an actual recession starts. There is almost always a sharp deceleration in growth in payroll employment in the year before a recession, for instance. America has experienced nothing of the sort.

Yet whether the market gyrations are rooted firmly in fundamentals or not, they could themselves be a source of economic instability. Falling asset prices could put a chill on investment or squeeze consumer spending, as households feel less wealthy. Falling currencies and rising bond yields in stressed economies increase the pressure on strained borrowers, raising the odds of some sort of destabilizing credit event. Emerging economies might also face pressure to raise interest rates to slow currency depreciation. At the same time, rising currencies in safe-haven economies reduce the competitiveness of exporters and drain off demand. And anywhere and everywhere, a sense of economic foreboding could depress confidence. A recession, after all, is nothing more than a rut of self-ratifying pessimism.

Not every market swoon knocks an affected economy into that sort of rut. The big worry now, however, is that governments have so little room to respond to a hit to confidence. When worries about Asian economies fed through to financial-market havoc in America in 1998, the Federal Reserve cut rates by 75 basis points. Markets recovered, and the expansion continued for over two more years. In 2002, the Fed responded to a prolonged slide in equity prices by cutting rates by 50 basis points. In 2010, the end of the Fed's first quantitative-easing programme prompted an outbreak of pessimism in financial markets. The Fed eventually responded by launching a new round of asset purchases: QE2.

Right now, the Fed doesn't have 50 basis points to cut (unless it decides to take the plunge into negative rates). This was always the risk in raising interest rates too soon; while the cost of delay was nothing more than the possibility of a short period of above-target inflation, the cost to a premature hike was the chance that the Fed would face an unexpected threat and not have the ability to respond as aggressively as the situation demanded. The Fed should have been especially sensitive to that threat given the fact that almost *none* of the world's big economies have much room to react to slackening demand. Almost all of the rich world is up against the zero lower bound on interest rates. China can and will loosen monetary policy but faces constraints as it does; looser policy accelerates capital outflows and places downward pressure on the yuan. The destabilizing force that has on global markets probably outweighs the benefit from easier policy within China. It was foolish to risk this outcome, given the persistent weakness of inflation and wages in America. But here we are, hoping that *animal spirits* find a way to perk themselves back up. They can't count on much help from policy-makers.