Blind Conservatism*

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This year's just-concluded spring meetings of the International Monetary Fund and the World Bank were marked by a mood of gloom among the world's leading policy makers. As recently as January 2018 the IMF had claimed that "the cyclical upswing underway since mid-2016" was growing stronger, contributing to "the broadest synchronized global growth upsurge since 2010". By October it felt that while "the global economic expansion remains strong", it had "become less balanced and with more downside risks." Now the mood is much more sombre.

The IMF's April 2019 edition of the World Economic Outlook finds that global growth has slowed significantly over the last year, from 3.8 per cent in the first half to 3.2 per cent in the second. The IMF attributes this to multiple factors, arguing that "the escalation of US-China trade tensions, macroeconomic stress in Argentina and Turkey, disruptions to the auto sector in Germany, tighter credit policies in China, and financial tightening alongside the normalization of monetary policy in the larger advanced economies have all contributed to a significantly weakened global expansion, especially in the second half of 2018."

The near term outlook too is not bright in its view, with growth in 2019 projected at 3.3 per cent, which is 0.4 percentage points lower than its own projection in October last year. Moreover, it notes that the risk of further such "downward revisions is high". Finally, the emerging market economies (EMEs) are expected to only marginally compensate for the poor performance of the advanced economies, by performing less badly than they had been doing earlier, with hopes pinned on an end to the crisis in Turkey and Argentina and stabilisation of growth in China, even if at a much lower rate than during its best years.

This assessment and prognosis is significant not just because of what it says about the current conjuncture, but for two other reasons. The first is that it amounts to the IMF admitting that a real and robust recovery from the low, "new normal" rate of growth of the world economy since the global financial crisis of 2008 is yet to occur. The second, is that this assessment comes when the world's policy makers have flogged to finish the principal measure they have used to address the Great Recession—an easy money policy combining quantitative easing with near zero or negative interest rates. Those measures have had little effect on growth but have fuelled speculation and contributed to unsustainable asset price inflation.

Advanced nation central banks are burdened with fattened balance sheets and interest rates are so low (near zero or negative) that, despite the logic they espouse of abjuring easy money policies only when inflation is high (which it is not), these central banks cannot justify persisting with these "unconventional monetary policies". But the fact that they have failed to find a lasting solution to chronic recession also makes it difficult for them to justify reversing these policies they have claimed were the panacea for slow growth. Unless they or the governments of the advanced nations can offer an alternative, which must shift emphasis from the monetary to the fiscal front.

In the US, as the effects of Trump's tax cuts and spending increases that widened the Federal budget deficit wore off, an economy that was running at a comfortable pace slowed. This forced the Federal Reserve to clarify that it would hold back on the next rounds of interest rate increases it had earlier announced. Last December the Fed had for the fourth time in the year raised its policy rate range to 2.25 to 2.5 per cent and announced that it would opt for another three hikes to take the range to 3-3.25 per cent. It had also said it would continue to unwind its bloated balance sheet by selling bonds and securities to the tune of $30-50 billion every month. But in March, noting that "growth of economic activity has slowed from its solid rate in the fourth quarter", the Fed decided to hold back on rate rises and scale down its planned monthly reduction in its bond holdings.

In Europe too, the mood is similar. The European Central Bank has officially announced that it will not change its interest rate policy, which by putting the rate on deposits with it at a negative 0.4-0.6 per cent imposes a tax on banks that is estimated to cost them Euro 7.5 billion a year. It has also committed to staying with its bond buying programme, which it had promised to withdraw.

These trends are being experienced at a time when there is uncertainty over how and to what extent the escalation of the US triggered trade war with Europe and China and the still undecided version of Brexit are likely to affect investor sentiment and growth. In the IMF’s view, while “the extended truce in the US–China trade dispute has provided a welcome respite” the policy backdrop is “otherwise turbulent” because of a mixed up list that includes “Brexit negotiations, discussions over the Italian budget, changes in Mexican policy direction under the new administration, the US federal government shutdown, and US policy on Iran.” If any or all of these do have an adverse effect, then sticking with a failed monetary response will not do. Governments not just in the G8 but the G20 will have to take a leaf out of the Trump book and launch an aggressive fiscal response, as was done with much effect immediately after the onset of the Great Recession in 2008, but abandoned because of the opposition from financial quarters to rising public deficits and debt.

This has put the IMF in a quandary, given its own reservations about a proactive fiscal stance on the part of governments. The IMF’s preferred policy is for governments to stick with their accommodative monetary policy and for the US to see good sense and pull-back on trade aggression so as to keep protectionist tendencies at bay. In its view, to boost potential output growth, “at the multilateral level, the main priority is for countries to resolve trade disagreements cooperatively, without raising distortionary barriers that would further destabilize a slowing global economy.” But that is not good enough in a situation that threatens to unravel in ways that can take the world economy back to the depths of 2008 or even lower.

The IMF recognises that: “Macroeconomic and financial policy should aim to prevent further deceleration where output could fall below potential and facilitate a soft landing where policy support needs to be withdrawn.” So, in a half-hearted concession to the obvious, IMF chief economist Gita Gopinath admits that if downside risks in an already downbeat world economy were to materialise, the situation “may require synchronised, though country-specific, economic stimulus complemented by accommodative monetary policy.” This is the position taken in the IMF’s Outlook assessment, which calls on countries to use both monetary and fiscal measures, though it holds that the headroom for a fiscal response is also limited. It cautions that the stance adopted should be country-specific, in the sense that it should take account of the state of public finances in a country. Thus fiscal policy should seek “to manage tradeoffs between supporting demand and making sure that public debt stays on a sustainable path. Where fiscal consolidation is needed and monetary policy is constrained, its pace should be calibrated to secure stability while avoiding harming near-term growth and depleting programs that protect the vulnerable.” With caution of that kind, the IMF is still only a short step away from austerity rather than expansion.

This grudging acceptance of the need to push for a coordinated fiscal response reflects not just the blind conservatism that characterises the IMF, but points to a failure to see the opportunity that the short run case for an expansionary fiscal stance in a recessionary, low inflation environment offers to help realise long term global goals. Whether it is the Sustainable Development Goals that nations have committed themselves to or the growing urgency to address the mitigation and adaptation challenges associated with climate change, financing is a real issue. As many have noted, by directing fiscal spending towards that agenda, the task of pulling the world economy out of a chronic recession can be pursued while working to advance human development objectives, in what is recognised as a virtuous global and green new deal.

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