Economics

There's no opting out from the looming slump

Larry Elliott
Economics editor

Tories who saw Cameron's veto as a golden dawn must be smoking something strong

A year ago, it was assumed 2011 would see life return to normal. Europe would sort out its little local difficulties, China and India would power along, and Barack Obama would use a resurgent US economy as the springboard for his re-election campaign.

One indication of how much things have changed is that back then, there was speculation on the timing of the first increases in interest rates in the UK and the US to fend off rising inflationary pressures. Many in the City thought that May was the likeliest month for the Bank of England to act. Wiser heads said May 2013, and today even that looks a touch on the hasty side.

Instead, 2011 ends with the euro fighting for its life, Britain weighing up what life might be like outside the EU, China fending off a hard landing, America in political gridlock and unemployment globally above 200 million and rising. Apart from that, everything's going swimmingly.

For those who like their humour black, there are some ironies to be savoured. British governments for the past three decades have had an aversion to the idea of picking winners, with the one exception of the City of London. That "winner" proved to be the biggest loser of the lot, yet David Cameron decided that defending the interests of this tarnished special interest group should be Britain's priority at last week's summit.

The real reason for objecting to the creation of the Herbert Hoover Appreciation Society (or fiscal stability pact) created by Angela Merkel and Nicolas Sarkozy is that it condemns Europe to permanent deflation and high unemployment, so the prime minister may well have made the right decision for the wrong reasons.

Then there's the nice role reversal in which the Europeans act like Anglo-Saxons and the Anglo-Saxons act like Europeans. The Brits and the Americans are supposed to like their economics pure and market-driven, yet have intervened like there's no tomorrow over the past few years, turning the money taps full on to drive down bond yields. The Europeans have the reputation for always wanting to meddle and tinker, yet have been unwilling to allow the European Central Bank to join the Bank of England and the Fed in their quantitative easing programmes. Jens Weidmann, the president of the Bundesbank, says central banks risk diluting "the incentives that come from the market" when they intervene. "Recent experience has shown that market interest rates do play a role in pushing governments towards reforms."

This assumes, as Dhaval Joshi of BCA Research notes, that market interest rates are giving the correct signals and incentives. "But there is strong evidence that the signals are wrong – or at least, exaggerated. It follows that any policy taking its cue from the market will also be wrong or exaggerated. Specifically, if governments are compelled to impose austerity to regain an irrational loss of investor confidence, then the market would needlessly turn Europe's incipient recession into something very nasty."

That's certainly the growing consensus among the economic forecasting fraternity, and notwithstanding the tendency of the City scribblers and their academic cousins to get it wrong, the outlook for Europe is bleak.

And not just Europe, either. Britain, courtesy of Gordon Brown and Ed Balls, has the benefit of being able to set its own monetary policy, a luxury denied those countries confined to the eurozone's debtors' prison. But those Tory backbenchers who saw last week's events as heralding a new golden dawn for the UK must be smoking something strong, because the UK faces years of hard graft – in or out of the EU – to restore competitiveness and rebuild the economy.

Gerard Lyons, the chief economist at Standard Chartered, says today that the eurozone will contract 1.5% by next year, while the UK will suffer a fall in output of 1.3%. He is more upbeat about the emerging world, although even there concerns are being raised about the speed at which the Chinese economy has come off the boil in recent months.

David Cameron at the EU summit – Britain may now be facing life as an EU outsider

One of the dangers in the west identified by Lyons is the risk of both macroeconomic and regulatory policies being pro-cyclical, the tendency of those in charge to carry on digging when they are in a hole. So in the eurozone, countries already suffering a deficiency of demand are told to deflate their economies still further, making it impossible for them to hit deficit reduction targets. Similarly, banks are being told by the regulators to build up much bigger capital buffers to make them safer, a policy that would have had great merit during the boom but, by restricting credit flows to firms, makes another downturn more likely.

If there is a silver lining to this very dark cloud, it is the likelihood that a fresh leg to the crisis will result in some fresh thinking. Some evidence for this comes in a Bank of England working paper released today which argues that it might be necessary to reintroduce capital controls and protection in order to repair the international monetary and financial system.

The Bank paper contrasts the Bretton Woods system of fixed exchange rates and capital controls that operated for a quarter of a century after the second world war with the system of partially floating exchange rates and deregulated financial flows that has existed in the four decades since.

Growth was higher, recessions were few and far between, and there were no financial crises. Governments were able to pursue domestic policy goals without the constant threat from destabilising flows of hot money. "The period stands out as coinciding with remarkable financial stability and sustained high growth at the global level," the paper notes. "Moreover, the solid growth outcomes were not simply the result of postwar reconstruction efforts – growth in real per capita GDP was slightly stronger in the 1960s than it was in the 1950s." The paper does add a caveat: it is impossible to say for sure, it says, whether the Bretton Woods system was successful in delivering high growth and stability or whether the high growth and stability made Bretton Woods a success. That's a fair point.

Even so, its assessment of the current international system is damning. A well-functioning mechanism, the Bank paper argues, should have three components: it should ensure internal balance, with governments able to deliver strong non-inflationary growth; it should allocate capital efficiently, and it should ensure financial stability.

The paper says: "Overall, the evidence is that today's system has performed poorly against each of its three objectives, at least compared with the Bretton Woods system, with the key failure being the system's inability to maintain financial stability and minimise the incidence of disruptive sudden changes in global capital flows."

The euro was an attempt to bring back some of the stability and certainty of the Bretton Woods system, albeit a deeply flawed one. Today, the euro is part of the problem rather than the solution.

According to the Bank paper, the flaws in the current international system are so serious that a "rules-based system of global economic management may be needed, using hard incentives such as tariffs or capital controls". That might give governments space to create jobs and enhance wellbeing, which is what economic policy is supposed to be about, after all.

larry.elliott@guardian.co.uk
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Reform of the International Monetary and Financial System; Financial Stability paper 12; www.bankofengland.co.uk