DISCUSSION PAPER

Is the World Ready for the Next Recession?

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Introduction

It has been more than ten years since the 2008 global financial crisis. Many experts claim that we are heading towards another global recession. However, unlike the 2008 crisis, governments and central banks do not have proper monetary and fiscal arsenals at their disposal this time. Public debt around the globe is at historic highs, while monetary easing strategies have been stretched to their limits. Interest rates have already hit the zero lower bound or even turned negative in some major economies, which economists used to think was impossible. Now, it is not certain what authorities will do to stimulate economic growth when the next recession hits.

Several signs indicate that the next recession may be close. First, after almost ten years since the last recession, it is time to expect a downturn in economic growth as is characteristic of business cycles. There is indeed a slowdown in economic growth in several major economies, including the US, China, Germany, Japan, and the UK. Second, the trade tension between the US and China adversely impacts international trade around the globe, which creates pessimism about the prospects of global growth. Furthermore, rising Brexit uncertainty in the UK represents a further drag on trade. Lastly, several developing countries, including Argentina, Iran, Venezuela, and, to a lesser extent, South Africa and Turkey, are also going through a rough patch in terms of growth.

More importantly, unlike the economic crisis in 2008, economies around the world, particularly in developed countries, do not appear to be ready for the next recession. Normally, economies are supposed to prepare for the recessions during boom years of the economic cycle. They do this by increasing interest rates and accumulating reserves so, in times of economic distress, they can reduce rates and dispose reserves to incentivize economic activities. However, since the last recession in 2007-8, central banks in developed countries have not been able to do this as growth rates have been slagging. Interest rates are already very low and governments still hold significant public debts accumulated during the last crisis. So, the global economy is facing a potential deadlock.

This paper seeks to address the reasons why the world economy may be headed towards a global recession and why governments and central banks around the world may not be ready for it. This rest on the claim that most developed countries currently lack the option of deploying traditional policy tools, which countries normally use to fight recessions. As proposed by a number of economists, one way out of this deadlock may be to employ a series of well-designed post-Keynesian fiscal policies. However, countries that still have fiscal space to accomplish this are limited. On top of that, they tend to be politically unwilling to take proactive fiscal action. Even if they do follow such unconventional measures, it is uncertain whether this will bring the intended result of preventing the global economy from falling into a synchronized recession.

Is a Global Recession Coming?

Typically, all economies experience fluctuations in economic activity over time, which economists refer to as the 'business cycle'. Economic expansion is almost always followed by a period of slow-down in growth, and an eventual recession until expansion takes over again and a new cycle begins. Many analysts argue that ten years after the global economic crisis of 2008, the next great recession may be lurking around the corner. Recent trends in economic growth, international trade, and financial markets strengthen this perception.

The US has had a long run of economic expansion since the 2008 global financial crisis. This has been the second-longest episode of economic expansion in American history, which also saw the unemployment rate drop to an 18-year low. However, many argue that this prolonged episode of economic expansion is due to the economic policies of Trump government, including tax cuts for the rich and increases in public spending, rather than sustainable long-run improvements (Harwood, 2019). Productivity growth is still stagnant while the US government still runs a huge deficit. Many analysts point out that the fiscal-stimulus policies that are currently pushing the annual US growth rate above its potential will not be able to sustain this trend for long.

A good indicator of the pessimistic perception in the markets is the so-called 'yield curve' (i.e. the gap between the yield on 10-year Treasury bonds and the yield on 3-month Treasury bills). Normally, longer-term bonds bring more return than the short-term bonds because they involve greater risk. However, when investors estimate a downturn, this difference tends to close and even turn negative, hence, the inverted yield curve. Although it is not a full-proof indicator, it has been worrying that the US yield curve has been quite narrow for some time. J.P. Morgan, for instance, reported last year that half of its ultra-rich clients with more $30 million investment expects a recession in 2020 (McRae, 2018).

One of the main sources of pessimism for the global economy is the rising trade tension between China and the US. In that respect, a potential trade war may be the spark of the next recession not only for the US but also for China (Basbay, 2019). China is an export-oriented economy and depends on its massive trade surplus with the US. China's huge manufacturing industries are unlikely to substitute their biggest market for anywhere else. It is also important to note that China has already been experiencing growth slow-down in recent years. In 2019, Industrial production growth hit a 17-year low and continues to set new records (Yao & Qui, 2019). Unless some reconciliation between the US and China can be reached, which most analysts see as unlikely at the current juncture, China will continue go through a deep economic transformation and restructuring of its economy, which will create a lot of uncertainty both for China and the world (Allison, 2017; Leonard, 2019).

Furthermore, when the two biggest economies of the world experience slowing growth, other parts of the world are inescapably impacted through their trade relations (Tillett, 2019). China is a major purchaser of primary products from developing countries and a big supplier of cheap intermediate and final goods to most economies around the world. If these two giant economies continue to clash on different issues, supply chains will necessarily be disrupted, costs will rise, and global trade volume will markedly decrease. Roubini (2019) even argues that the world is headed towards a kind of economic cold war, which will create two separate economic spheres. Under such a scenario, a growth slowdown would be the least of the world's worries.

Table 1: **Annual GDP Growth Averages** *(%)*

	2000-2004	2005-2009	2010-2014	2015-2018
United States	2.71	1.11	2.13	2.38
Germany	1.02	0.63	2.18	1.89
United Kingdom	2.90	0.73	1.96	1.84
Japan	1.41	-0.35	1.59	1.14
China	9.22	11.48	8.62	6.75
Middle Income	5.29	6.25	5.60	4.40
World	3.16	2.52	3.08	2.91

Source: World Bank

The UK is another major economy that is currently in trouble. The Brexit process continues to pose a major challenge to the economy. While a no-deal Brexit is still a possibility, Prime Minister Johnson's uncompromising approach to the negotiation process has led to even more fury and pessimism among investors. According to the Bank of England, in case a no-deal Brexit scenario is realized, the British economy may not be able to deal with the consequences for a considerable time. The Bank estimates that GDP would decline by 5.5%, unemployment would double to 7%, and inflation would more than double to 5.5% (Partington and Wearden, 2018). The country's financial market, very diverse labour force - most of whom are from EU countries - and significant dependence on imports for main food items and intermediate products increases the scale of the risk.

Germany, another major European economy, has already entered a recession as of the second quarter of 2019. Finance Minister Olaf Scholz announced that the government could spend an extra €50 billion to stimulate economic activities and avoid a recession. However, many argue that this may be too little, too late. Most analysts expect another quarter of contraction, which is -technically speaking - the definition of a recession (Nienaber, 2019). It is too early to tell if the recession will last or deepen, but unless China's growth is revived, things may get a little more worrying for Germany simply because China is Germany's number one destination for exports. Germany's trade relations are also in jeopardy because of President Trump's trade policies. President Trump has repeatedly threatened EU countries with additional tariffs, opening a new front in the trade battle.

The situation is not very hopeful in other parts of the world either. Many developing countries, including Argentina, Venezuela, Iran, South Africa and Turkey, are also in an economic recession or are experiencing slowing growth. For now, they enjoy the capital inflow leaving low-interest developed economies and the luxury of paying a little lesser for capital than they normally do. However, as economic growth slows in advanced economies, so does demand for imported products. Most developing countries depend on exports to developed economies so a growth slow-down in developed economies usually translates into a growth slow-down in developing countries as well.

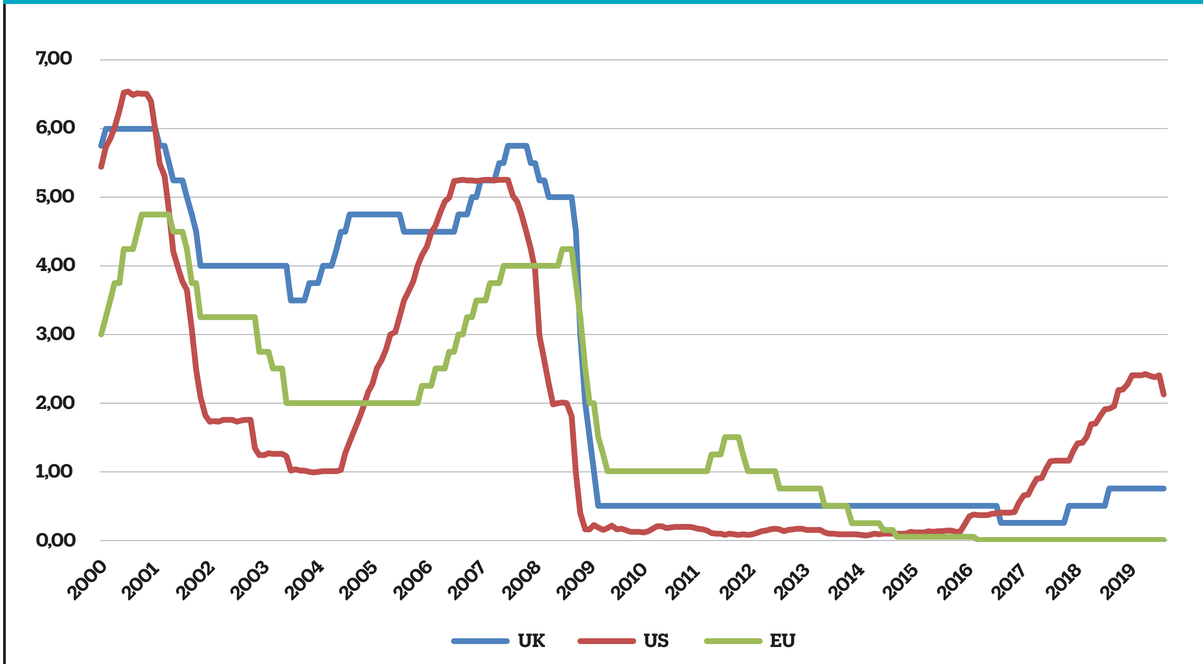
Why the Global Economy is not Prepared

Central banks have a mandate from their governments to keep prices stable and promote maximum employment. Typically, when economic growth is on track and unemployment is low, central banks increase their interest rates to limit money supply and avoid inflation. In doing so, they may also dispose of assets on their balance sheet and pile up cash. So, when a recession hits, they reverse this policy and release cash back into the economy, which economists refer to as monetary easing. This would, in turn, reduce the cost of borrowing and boost investments and economic growth. Therefore, altering interest rates as well as buying and selling bonds in the open market are the main mechanisms through which central banks can manipulate investment and consumption decisions, and boost aggregate demand and economic growth when needed.

Both during and after the 2008-9 financial crisis, central banks relied heavily on such expansionary monetary policies. Policy rates have dropped to near-zero levels while central bank assets have greatly expanded. Today, the main source of concern is that central banks have not been able to reverse this policy. The expectation was that, in this environment of cheap credit, business could pick up again and economies could recover from the crisis. Economies did recover to some extent, however, not to the extent that was expected. Because economic recovery has been relatively weak and growth did not return to its pre-crisis levels, the conditions under which central banks would normally increase interest rates have not manifested, and the trend of cheap credit continued.

This explains why central banks around the world have recently attracted unusual attention for interest rate decisions. First, the European Central Bank, then the US Federal Reserve, and finally several other central banks around the world have dropped their interest rates. The problem with this wave of lowering interest rates is that the policy rates of central banks are already close to zero, meaning that their capacity to stimulate economic activity is being further depleted. Many fear that developed economies might once again hit the lower zero bound, by which economists refer to a situation where economic activity does not pick up even though interest rates are already very low. Such a situation leaves central banks with nothing to do as there is no space to lower interest rates any further. Now, it is not certain what central banks will do in case the current momentum of decreasing growth continues.

Table 2: **Central Banks' Policy Rates** *(%)*



Source: Central Banks

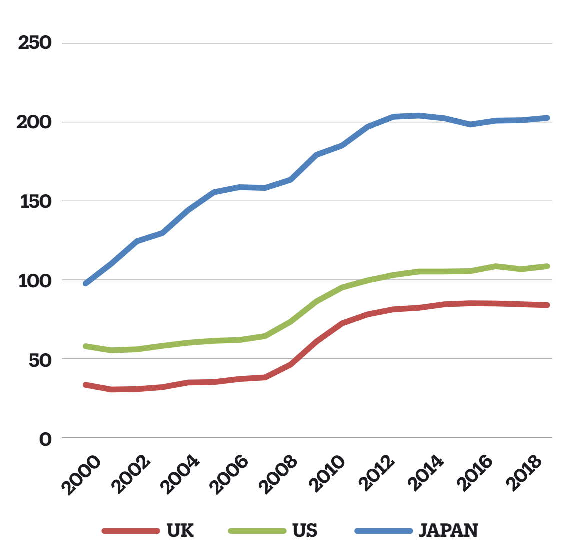
Central banks are trying to navigate their way out of this unprecedented monetary experiment. The US Fed had been increasing interest rates since 2017 as growth was picking up, and announced that they would make another 3 interest rate hikes in 2019 and aim for a range of 3-3.5%. As part of the plan, the Fed was aiming to sell between $30-50 billion worth of bonds and securities every month. If realized, this would put an end to the extreme monetary experiment of record-low interest rates that have been the standard since the 2008 global financial crisis. However, in light of growing fragilities in economic performance, in March 2019, the Fed announced that it would postpone unwinding its balance sheet. It twice lowered its rate to a range of 2-2.25% as of the end of July. It should also be mentioned that US President Trump has openly pressured the Fed to lower its interest rates even further.

The European Central Bank's policy rate has been at near-zero levels since late 2014 and the banks' asset position keeps expanding since then. With the latest reduction, the real interest rate is now below zero, which means that the bank is paying a premium for lending. The situation is no different for the Bank of England or the Bank of Japan. The big question is whether this new wave of monetary easing will give the much-needed boost to investment and consumer spending. Even Mario Draghi, President of European Central Bank, himself warned in this last announcement that there is little left in his (or his successor's) arsenal to fight deflationary pressures in the Eurozone. Notable economists, including Summers and Stansbury (2019), claim that the best central banks can do at this point is to admit their inability to control inflation and fight a potential recession through traditional channels so policy-makers can focus on other solutions.

The 'other solution' Summers and Stansbury (2019) - and some others - have in mind is fiscal policy. They suggest that governments should start spending more to boost aggregate demand and stimulate economic activities. Normally, in times of economic downturn, governments may choose to run budget deficits (i.e. spend more than its revenue). The downside of this is, of course, increasing government debt. In theory, as economies recover, governments can gradually lower spending below its revenue to make up for the extra spending during the recession. In this way, governments can smooth business cycles and avoid deep and prolonged recessions without hurting public finances. In his announcement of further monetary easing, Mario Draghi also urged governments to take action through fiscal stimulus.

However, there isn't much optimism about the current ability of governments to counter a recession through fiscal policies either. The space for fiscal stimulus is very limited due to already accumulated public debt, especially in the case of the US. At the beginning of 2019, US public debt was around 105% of its GDP, amounting to around $22 trillion. In 2008, this figure stood at 64% right before the financial crisis. Public debt has not seen the levels it has reached today since World War II, reaching record levels in December 2018. Given that the US government already sits on such a high public debt, debt financing a fiscal stimulus does not seem like much of a viable option at this point.

Table 3: **Public Debt** *(% of GDP)*



Source: CEIC

The conundrum facing the US is that to continue borrowing, it has to keep increasing interest rates. Otherwise, investors will be less and less willing to buy US bonds due to the constantly rising overall debt volume. This, in turn, rules out the chance of further monetary easing. The US is thus facing the choice between ever-increasing government debt and increasingly ineffective monetary easing. Economists who favour fiscal stimulus over monetary easing are calling for a fundamental change in the way policy interventions to business cycles are perceived with important theoretical underpinnings. To be more precise, they are demanding a surfacing of post-Keynesian economics which sees fiscal policy as the most appropriate remedy for a recession (Summers & Stansbury, 2019; O'Neill, 2019: Kotz, 2019).

Rising government debt is not unique to the US. Globally, government debt reached record levels of 224% of global GDP in 2017, compared to just 60% in 2007 (UNCTAD, 2019). Advanced economies such as the UK, Japan, and France are already fighting heightened government spending due to ageing populations and strained health and pension systems. Therefore, they seem to have neither any political will nor the capacity to increase spending in the face of coming next recession. One important exception to this is Germany, which has managed to adhere to a balanced-budget policy for some time. A European economic revival seems to depend on a big German fiscal stimulus in coming years. However, it is not certain if Germany will be willing, or able, to take the lead in saving the Eurozone (Kotz, 2019).

Conclusion

It appears that the global economy may be heading towards a synchronised recession in 2020. What is truly worrying is that governments and central banks around the world have not been able to reverse expansionary policies adopted during the 2008 global financial crisis. Such low levels of interest rates for such prolonged periods have never been witnessed in modern history. If the current pattern of declining economic growth continues and, even worse, turns into a full-scale crisis, the central banks of major economies will not have any more space to lower interest rates. Furthermore, public debt accumulated through deficit spending has reached unprecedented levels in recent years. Therefore, it is not certain if governments can, or would, resort to a fiscal stimulus.

Both governments and central banks seem to have exhausted the traditional channels through which they can mitigate the consequences of a potential recession. According to some economists, the only way out of the current global stagnation may be a deeper paradigm shift in policy-making. A well-planned fiscal policy following the prescription of the long-forgotten Post-Keynesian tradition has the potential to save the global economy and put it on a new balanced path of increased growth (Summers & Stansbury, 2019). Governments can invest in infrastructure and other sources of productivity growth, which would stimulate the economy in the short run. In the meantime, the global economy would be given the space to recover, leading to an increase in sustainable growth in the long run and thereby allowing for the offset of accumulated debts (O'Neill, 2019). Yet unfortunately, the problem with this solution is that governments that can implement such a program are unwilling to do so while those who need it most are unable to.

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