Why it would be wise to prepare for the next recession

By Martin Wolf 5 February 2016

Martin Wolf is Associate Editor and Chief Economics Commentator at the Financial Times, London. He was awarded the CBE (Commander of the British Empire) in 2000 for services to financial journalism. He was made a Doctor of Science (Econ), *honoris causa*, by the London School of Economics in December 2006. Mr Wolf was appointed a member of the UK government's Independent Commission on Banking in June 2010.

What might central banks do if the next recession hit while interest rates were still far below pre-2008 levels? As a paper from the London-based Resolution Foundation argues, this is highly likely. Central banks need to be prepared for this eventuality. The most important part of such preparation is to convince the public that they know what to do.

Today, eight-and-a-half years after the first signs of the financial crisis, the highest short-term intervention rate applied by the Federal Reserve, the European Central Bank, the Bank of Japan or the Bank of England is the latter's half a per cent, which has been in effect since March 2009 and with no rise in sight. The ECB and the BoJ are even using negative rates, the latter after more than 20 years of short-term rates of 0.5 per cent, or less. The plight of the UK might not be that dire. Nevertheless, the latest market expectations imply a base rate of roughly 1.6 per cent in 2021 and around 2.5 per cent in 2025 — less than half as high as in 2007.

What are the chances of a significant recession in the UK before 2025? Very high indeed. The same surely applies to the US, eurozone and Japan. Indeed, the imbalances within the Chinese economy, plus difficulties in many emerging economies, make this a risk now. The high-income economies are likely to hit a recession with much less room for conventional monetary loosening than before previous recessions.

What would then be the options?

One would be to do nothing. Many would call for the cleansing depression they believe the world needs. Personally, I find this idea crazy, given the damage it would do to the social fabric.

A second possibility would be to change targets, possibly to ones for growth or level of nominal gross domestic product or to a higher inflation rate. It would probably have been wise to have had a higher inflation target. But changing it when central banks are unable to deliver today's lower target might destabilise expectations without improving outcomes. Moreover, without effective instruments a more ambitious target might just seem empty bombast. So the third possibility is either to change instruments or to use the existing ones more powerfully.

One instrument, not much discussed, would be to organise the deleveraging of economies. This might need forced conversion of debt into equity. But, while desirable in extreme circumstances, this would be practically difficult.

Another would be a still bigger scale of quantitative easing. At the end of the third quarter of last year, the BoJ's balance sheet was 70 per cent of GDP, against less than 30 per cent for the Fed, the ECB and the BoE. The latter three could follow the former. Moreover, the assets they buy could be broadened, one possibility being foreign-currency bonds. But that would be provocative and unnecessary. The BoJ and ECB have engineered big currency depreciation without making it quite so blatant.

Yet another instrument is negative interest rates, now used by the ECB, the BoJ and the central banks of Denmark, Sweden and Switzerland. With clever gimmicks, it is possible to impose negative rates on bank reserves at the margin, thereby generating negative interest rates in markets, without imposing negative rates on depositors. How far this can be pushed while cash is still an alternative is unclear. Beyond a certain point, people seek to move into cash-backed warehouse receipts, unless a penal tax were imposed on withdrawal from banks or cash were abolished altogether. Moreover, it is unclear how economically effective negative rates would be, apart from lowering the currency.

A final instrument is "helicopter money" — permanent monetary emission for the purpose of promoting purchases of goods and services either by the government or by households. From a monetary point of view, this is the equivalent of intentionally permanent QE. Of course, actual QE might become permanent after the event: that is now likely in Japan. Again, supposedly permanent monetary emission might turn out to have been temporary, after the event. But if the money went directly into additional spending by government or into lower taxes or to people's bank accounts, it would surely have an effect. The crucial point is to leave control over the quantity to be emitted to central banks as part of their monetary remit.

Personally, I would prefer the last instrument. But at this stage it is crucial to recognise the great likelihood that something even more unconventional might have to be done next time. So prepare the ground beforehand. Central banks should be filling in these blanks now, not after the next recession hits.

Martin Wolf