Case for optimism rests on policy

With Europe, Japan split, US and China can act

by John Plender

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The developed world remains over-dependent on central bankers to keep the economic show on the road. There are growing fissures within central banks – notably the European Central Bank and the Bank of Japan – over the extremity of measures required to fend off recession and deflation. The supposedly independent Japanese central bank has become a tool in the hands of Shinzo Abe, the fiercely expansionist prime minister. This is perilous territory, where the potential for good or bad economic outcomes is finely balanced.

Market psychology has switched with remarkable speed. As Janet Yellen, the US Federal Reserve chair, indicated on Wednesday night, the US central bank is softening its commitment to higher interest rates. Back in December, when the Fed raised its policy rate for the first time in almost a decade, the big difference of opinion between the Fed and Wall Street was over the number of times rates would have to rise in 2016. Today, many are betting on no rise at all and there is much talk of a US recession.

In between, the markets have been rattled first by worries about a hard landing in China and collapsing oil prices, then by a tightening of US financial conditions as a result of a strengthening dollar and rising credit costs for weaker borrowers. A growing proportion of the global bond market is now in negative yield territory, prompting renewed talk of deflation. Adding to the sense of panic has been the plunge in bank share prices in Europe – partly reversed on Wednesday – which some investors fear may indicate a far deeper malaise.

All this is very paradoxical. While the emerging markets are acting as a drag on global growth, the developed world is enjoying a hugely beneficial supply shock as a result of collapsing energy prices. For the Americans, this is double-edged because energy companies are being decimated. Even so, the net outcome is positive thanks to the oil windfall enjoyed by households and much of the rest of the corporate sector. And in Europe, which lacks a comparable energy sector, the outlook is that much better.

It is true that industry in the US is in recession. But the service sector is buoyant and job creation is robust, as is bank lending. Despite December's quarter point interest rate hike, monetary policy is still essentially accommodative.

Investors may be generating a bear market without the traditional accompaniment of recession. Some of the usual harbingers of recession are missing, such as an inverse yield curve. Yet there are also troubling grounds for thinking that the markets may be on to something. This is, after all, an underpowered, relatively mature recovery in the wake of the 2008 crisis. The problem of excess savings and deficient demand is still with us.

At the same time, a big overhang of public sector debt has grown even bigger. The banking system in Europe remains undercapitalised and the structural flaws in the euro system are unresolved.

The basis of the post-crisis rebound is more than a little fragile. In such circumstances, as Yellen acknowledged, consumer and business confidence becomes exceptionally important. If financial conditions remain tight and markets stay jumpy, household spending and corporate investment may be deferred.

The case for optimism rests on policy. The Fed does not have to tighten further. If need be, it could reverse the December hike. Worries about China's structural slowdown are probably overdone. Despite a disturbing build-up of debt, Beijing still has some fiscal capacity to address a crisis and is predisposed towards monetary activism. Amid the February gloom, there is room for hope.

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