Fear returns

Governments were the solution to the economic crisis. Now they are the problem.

IT'S not quite a Lehman moment, but financial markets are more anxious today than at any time since the global recovery took hold almost a year ago. The MSCI index of global stocks has fallen by over 15% since mid-April. Treasury yields have tumbled as investors have fled to the relative safety of American government bonds. The three-month inter-bank borrowing rate is at a ten-month high. Gone is the exuberance that greeted the return to growth (see article). Investors are on edge.

What lies behind these jitters? New nervousness about geopolitical risk, with tensions rising in the Korean peninsula, has not helped. But that comes on top of two wider worries.

One is about the underlying health of the world economy. Fears are growing that the global recovery will falter as Europe's debt crisis spreads, China's property bubble bursts and America's stimulus-fuelled rebound peters out. The other concerns government policy. From America's overhaul of financial regulation to Germany's restrictions on short-selling, politicians are changing the rules in unpredictable ways (see article). And the scale of sovereign debts has left governments with less room to counter any new downturn; indeed, many of them are being forced into austerity.

The danger is that these fears reinforce each other in a pernicious reversal of the dynamics of 2008-09. Then, co-ordinated government action on a grand scale stopped the global financial crisis from turning into a depression. Now, thanks to incompetence and impotence, governments may become the problem that will drag the world economy down.

Don't panic

That is far from inevitable. Fears about the fragility of the global recovery are exaggerated. Led by big emerging economies, the world's output is probably growing at an annual rate of more than 5%, far swifter than most seers expected.

This pace will, and should, slow, not least because the big emerging economies need to tackle rising inflation and possible asset bubbles. China is in obvious danger, which is why its government has tried to constrain loans and property prices. Pricking asset bubbles is never easy, but there is scant evidence that its efforts are too heavy-handed (see article).

America's growth may also slow as firms stop rebuilding their stocks and the government's stimulus tapers off. But the world's biggest economy does not seem on the verge of a second recession. For all their heavy debts, American consumers have returned to the shops. Their confidence is rising as the economy is producing jobs (albeit not enough of them). And Congress seems likely to slow the pace of fiscal tightening with a new "mini-stimulus" of temporary spending (see article).

Growth prospects look grimmest in Europe. Yet even there the likely immediate outcome of the euro zone's crisis is the enfeeblement of an already weak recovery, rather than a sudden slump. The region's profligate economies will struggle for longer as austerity kicks in. But waning confidence will be mitigated by the boost that exports receive from the euro's plunge.

Look only at those probable short-term prospects and it is hard to see why financial markets are suddenly in such a lather. The reason is that the risks of a far worse outcome have risen, and those risks lie mainly with governments.

Grading the governments

The place with the wobbliest policy is Europe. For the euro to survive, Europeans need to be prepared not just for painful fiscal adjustment but for profound structural reform as well. Profligate governments, mostly in southern Europe, must become more prudent. Uncompetitive economies must shake up their labour and product markets. Countries that are running current-account surpluses, mainly in the north, must help, by avoiding overzealous belt-tightening and introducing reforms to encourage private spending. And the European Central Bank (ECB) should counter the fiscal austerity with a looser monetary policy. Reducing real wages in Spain would be easier if euro-zone inflation were higher.

Unfortunately, Germany's government seems to be drawing exactly the opposite conclusions, promising to set an example with tough cuts when it should be helping to stimulate growth. The worry is that, under German pressure, the ECB will have the same misguided tendency to toughness, condemning the euro area to years of stagnation.

Governments outside the euro zone are also at risk of drawing flawed conclusions, especially on exchange rates and fiscal policy. China seems to think that the euro's decline makes it less urgent to allow the yuan to appreciate. The opposite is true. With its biggest export market in a funk, China needs to accelerate the rebalancing of its economy towards domestic consumption, with the help of a stronger currency.

For much of the rich world, however, the most important consequences of Europe's mess will be fiscal. Governments must steer between imposing premature austerity (in a bid to avoid becoming Greece) and allowing their public finances to deteriorate for too long. In some countries with big deficits, the fear of a bond-market rout is forcing rapid action. Britain's new government spelled out useful initial spending cuts this week. But the emergency budget promised for June 22nd will be trickier: it needs to show resolve on the deficit without sending the country back into recession.

In America, paradoxically, the Greek crisis has, if anything, removed the pressure for deficit reduction, by reducing bond yields. America's structural budget deficit will soon be bigger than that of any other OECD member, and the country badly needs a plan to deal with it. But for now, lower bond yields and a stronger dollar are the route through which American spending will rise to counter European austerity. Thanks to its population growth and the dollar's role as a global currency, America has more fiscal room than any other big-deficit country. It has been right to use it.

The world is nervous for good reason. Although the fundamentals are reasonably good, the judgment of politicians is often unreasonably bad. Right now that is what poses the biggest risk to the world economy.

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