

Too weak for a liquidity injection

There is a high risk that the next recession will be severe – either prolonged or unusually deep. The fundamental problem is that asset prices have risen to high levels relative to incomes. This applies to shares, houses, other forms of real estate, gold and even art. With assets so far out of line with incomes, either asset prices will have to fall in nominal terms or incomes will have to rise at an inflationary pace. It will be extremely difficult to manage the economy during the adjustment process, whether the route is rising inflation or falling asset prices.

The reaction of governments and central banks to the 2001 recession was to stimulate demand by both fiscal and monetary means. That was highly successful, partly because of good luck with the timing of tax cuts in the US, which were announced in November 2000, before the recession was expected.

A marked feature of the recovery was that it required an unusually large injection of liquidity. Sharp rises in asset prices accompanied, and were almost certainly caused by, this surge in liquidity. High asset prices stimulate economies because they reduce savings. While the liquidity medicine was effective, the huge dose required means that the disease has probably acquired some immunity to this treatment and will not respond so well next time.

Monetary policy works by driving up asset prices, so the policy is best applied when asset prices are depressed. But stimulating demand by pushing up overvalued assets to even more exalted levels involves serious medium-term risks while equilibrium is restored.

Recession catalyst

I believe that the world's central banks will not willingly allow the disparity between asset prices and incomes to be adjusted by inflation, so the next recession is likely to be set off by falling asset prices. This time, unlike in 2000 and 2001, house prices are likely to decline along with share prices.

When asset prices fall, one of the key ways in which easy monetary policy causes economic recovery will be absent. In addition, budget deficits, particularly in the US, are much higher than they were in the last recession, which will make it more difficult to use fiscal stimulus. Thus in the next recession, the economy is likely to respond only weakly to stimulus



Fiscal stimulus is unlikely to aid economies in the next recession as it has done in the past, writes Andrew Smithers

from either fiscal or monetary policies and, unlike on the last occasion, fiscal stimulus will not be introduced until the recession is already upon us.

The stock market usually manages to forecast a recession, although sometimes it gives a false alarm. A falling stock market is likely to be a necessary condition for the next recession and will probably start about nine months to a year before the economy records its first quarter of negative growth.

Stock buying

In the past three years, and particularly during 2006, stock markets have been pushed up by large scale buying from companies. In the US, they have been virtually the only major class of buyer. Individuals, both directly and via mutual funds, have been large sellers, and pension funds and insurance companies have stood on the sidelines.

This process can only continue while loans are available on increasingly risky terms. Competition among lenders has already driven down margins and now involves extending credit to increasingly risky ventures. Central banks and others draw regular, but apparently unavailing, attention to the deterioration in credit standards that is taking place.

Many things could provide the proximate cause for stock markets to fall but the fundamental cause will be their overvaluation, and in the aftermath lenders will become increasingly nervous. As credit conditions tighten, companies will no longer be able to buy shares so freely. Without corporate buying, the stock market is without visible means of support.

As share prices fall, households are likely to increase their savings and this will set off a vicious circle: the fall in demand from higher savings will cause profits to fall and that will lead to further falls in share prices. As demand weakens, unemployment will rise and falling house prices will contribute to further increases in household savings and further weakness in demand.

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The Bracken column is named after Brendan Bracken, the founding editor of *The Banker* in 1926 and chairman of the modern-day Financial Times from 1945 to 1968. This column reflects his enormous contribution to the open discussion and understanding of international finance and banking. It focuses on providing views and perspectives on how to improve the global financial system.