What kind of recession is this?

By Shellie Karabell

Not since the Great Depression has the world economy seen such a perfect storm of failed policies, rising unemployment and stalled growth. Many use the “R” word … but is that “recovery” or “recession”?

‘I think it’s a ‘special recession’,” says INSEAD Economics Professor **Antonio Fatás**, who is also the Portuguese Council Chaired Professor of European Studies.

“It’s a recession that we knew would not have a very strong recovery because of the debt overhang.” Economic indices from around the world support this: unemployment hovers around 10 percent in most industrialised countries…as high as 20 percent in Spain, and higher across the board in the under-25 age group. Manufacturing, consumer spending, and GDP growth are flat in the West. So are interest rates. The only thing on an upward trajectory in the industrialised world to day is government spending. And sovereign debt dead-even with GDP has sounded alarm bells in treasury departments around the world.

But what is the bigger threat to the economy? Cutting deficits or creating jobs? Solving which problem will bring the recession to an end? Which policy will ensure future growth?

Cut deficits or create jobs?

“There is absolutely no need to cut spending today or raise taxes today,” says Fatás. “Where we’re failing is on the political side. Sometimes the markets seem to be asking for more and politicians feel they need to do more than they’re doing; and you have the usual ideological discussions about what the role of government should be and certain parties will take advantage of these crises to try to impose their views on society: those who like small governments will try to push for an agenda now which is to cut spending and reduce the size of government.”

In the United States, a September 16 New York Times-CBS News poll shows that Americans don’t see the whopping U.S. budget deficit or big government as the main problem and they’re unconvinced that spending cuts and “reckless deregulation” will solve the real problem: jobs. The poll showed 8 in 10 of those surveyed favoured building roads, bridges and schools as well as cutting payroll taxes to make creating those jobs easier.

“Now is not the time to react aggressively and compensate for all the mistakes government have made over the past 3-4 decades,” Fatás continues. “Growth is the main objective now, not austerity. Austerity and discipline is required over the medium and long-run. There is no reason why austerity has to start this quarter or even this year,” he continues, in an oblique reference to the UK government’s determination to reduce their national debt significantly in just one session of parliament.

“I think what needs to be understood is that governing that problem (cutting deficits while still creating jobs and growth) is a long-term problem,” Fatas opines. “It’s not a problem of 2011/2012; it’s a problem of the next eight decades. And what you need is a framework that says over the next decades we the government are going to behave in such a way that will keep this under control. No, that’s not easy, given how politics works, with elections every four years or so. It’s hard to talk about long-term but that’s what’s needed.”

Are downgrades important?

Failure to come to grips with the deficit problem on any front has led to downgrades by various ratings agencies – of the United States, Japan, and of France's big three banks. Fatás is unruffled. "Economies have been talking about a debt crisis for more than 20 years now, so to me it's not a surprise, and a downgrade here and there doesn't change my perspective... the downgrades of the French banks are so far not that important. Their rating is still at the level of the ratings of most global banks and I think the market is over-reacting…yes, there are risks in Europe but most scenarios, even if they are not pleasant, will be managed by the European Central Bank (ECB) and European governments.. I do not foresee nationalisation of French banks…but having said all that, I'm pessimistic and I don't see governments reacting fast enough. For decades governments have not reacted to the problem of increasing debt."

Calls within the Euro zone for a central "über-financial" institution have been largely unheeded, as have suggestions of creating Eurobonds to sell off the debts of Euro-debtor nations in pan-Euroland chinks. Both France and Germany formally nixed the idea over the summer, and Fatás agrees with that decision. "To launch a Eurobond you have to say that all the taxpayers behind the Euro are responsible for the spending of any country within the Euro zone," he explains. "Now that's probably something that's not legal, given all the constitutions and legal systems in these countries, and if this was put to a referendum I'm almost sure that it would be voted down. This is not just a technical issue – it's a political matter, saying 'you the taxpayer in France, in Germany, in Italy are responsible for the spending of Greece, Ireland, etc' is not going to work."

The markets – equity and debt alike – have themselves been looking for ways to spread their own risk amidst uncertainty and triple-digit index swings. Gold has returned as the classic hedge pushing prices to record highs, while a summertime rush to the Swiss Franc finally forced the Swiss Central Bank to peg its currency to the Euro to stabilise its currency. In the first half of September, investors had moved back into U.S. treasuries, despite low interest rates, as the less-risky haven around. But it might not take much to turn these market jitters into panic, says Fatás.

Cautious optimism

“I’m worried about two things, which could come together,” he says. “One, if governments insist on having very restrictive fiscal policies over the next three years, that is gong to be bad news for the economy: cutting the debts, cutting spending over the next three years. And if in addition that instills some kind of panic in financial markets and investors (because of subsequent stalled growth and high unemployment), we could go into another recession.” Fatás adds he’s optimistic that won’t happen because “I hope fiscal policy will be more reasonable than what we’ve seen over the past six months.”

He’s also optimistic if he stands back and takes a macro-view of the global economy. “If you don’t focus on any one country, the world has not done that badly in the last 10-15 years,” he states. “I think the world has been able to grow fairly fast…certainly the countries that have done best are the countries we call ‘emerging markets,’ but again all countries benefit from growth, so it’s in the best interest of all economies to see those emerging markets growing again at a very healthy rate over the next decade.”

*Antonio Fatas and fellow INSEAD economics professor Ilian Mihov collaborate on a blog on Global Economy. Click **here** to view.*

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