TOMORROW'S CHALLENGES

BETRAYALS AND BAZOOKAS: WELCOME TO 2015

THE WORLD WON'T FALL INTO RECESSION THIS YEAR, BUT ANXIETY IS RUNNING HIGH

By IMD Professor Carlos A. Primo Braga – February 2015

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At the beginning of every year economists (and astrologers) are asked to read the "tea leaves" and predict how the world economy will fare in the next 12 months. In 2012, amidst the anxiety associated with the euro crisis and the possibility of a "Grexit," I was asked whether 2013 would be marked by a global recession. My answer—in a paper published in the journal Research World and abridged here—was no.

In a sense, my task was an easy one. The most commonly accepted definition of a global recession is a contraction in world real per capita GDP accompanied by declines in other key indicators such as international trade, oil consumption, employment and industrial production. This demanding definition means global recessions only happen in extreme circumstances, such as in 2009 in the aftermath of the financial meltdown.

Anxiety is running high again in 2015. Volatility is back, big time, owing to geopolitical tensions in Eastern Europe and the Middle East, terrorism attacks around the world, political instability in the European periphery (Greece again), a commodities-price crash, and radical moves by central banks. We will not witness a global recession this year either, but the situation today is even more fluid than it was in 2012. Accordingly, the basic message is "buckle-up," because it is going to be an interesting ride.

Central banks on the move

January 2015 saw two major actions by European central banks. First, the Swiss National Bank (SNB) decided on January 15th to abandon its policy of defending a floor of CHF1.20 against the euro. One week later, the European Central Bank (ECB) announced that it would engage in quantitative easing (QE) via an ambitious bond-buying program.

The SNB had introduced its policy in September 2011 to avoid an excessive appreciation of the Swiss franc, which, like the US dollar, is a safe-haven currency in times of crisis. As a consequence, the SNB had to buy a significant amount of euros over the last few years to maintain the floor. The SNB's balance sheet became overweight in euros (roughly 50% of its foreign currency holdings) and its total assets climbed to 85% of Swiss GDP—far bigger than the balance sheets of the U.S. Federal Reserve and the Bank of Japan vis-à-vis their respective economies. As it became clear that the ECB was going to unleash its own version of QE, and most probably cause the euro to depreciate, the SNB decided to cut its losses.

It is worth mentioning that the SNB has an unusual governance structure. Since private investors hold roughly 45% of its equity, the SNB is much more concerned than most central banks about potential balance sheet losses. The SNB's decision could be characterized as a preference to accept a big loss now while avoiding a dangerous trend towards growing euro exposure.

It was, however, a disruptive move. It will generate significant adjustments not only in Switzerland, but also in many Eastern European countries where people had borrowed in francs to benefit from low interest rates. Moreover, it illustrated the fact that central bankers do have a "license to bluff." In the weeks before the policy shift, the SNB had consistently stated that it would "continue to enforce the minimum exchange with utmost determination." The credibility of central bankers in using forward guidance to shape market expectations has now been significantly damaged. Not surprisingly, the initial reaction of Swiss exporters and private banks (with costs in francs and most of their revenues in foreign currencies) ranged from disbelief to a sense of betrayal.

The ECB's decision, by contrast, was expected, but the format brought some surprises. The QE program involves the purchase of EUR 60 billion of bonds per month from March onwards, and is expected to last at least until September 2016. True, this EUR 60 billion number includes roughly EUR 10 billion of asset-backed securities and covered bonds that are already being bought each month. Nonetheless, the program will entail almost EUR 1 trillion in sovereign asset purchases over the coming months. Moreover, by linking QE to the objective of reaching the ECB's inflation target of just under 2 percent, the ECB signaled that it will keep broad discretion in terms of when to end the program.

Initial market reactions to ECB president Mario Draghi's "big bazooka" were positive. Easy money is expected to grease the wheels of financial markets and hopefully lead to greater lending by commercial banks, while contributing to the depreciation of the euro and an increase in net exports.

There are, however, some unusual aspects to the ECB's QE program that are open to criticism. First, to get the support of Germany and other fiscally conservative eurozone countries, the program has adopted a cautious approach to bond buying. Most of the acquisitions (80%) will be made by national central banks rather than the ECB, which will limit the danger of financial risks being redistributed across countries and ease concerns about moral hazard. At the same time, by limiting the mutualization of risks in the eurozone, QE is likely to be less effective exactly where it is needed the most: in countries that needed EU-IMF assistance. Second, given the current regulatory emphasis on appropriate capitalization of financial entities, it is not clear that additional cheap money will lead to more lending.

The real bazookas

These recent monetary developments are happening against a background of growing geopolitical tensions. Real bazookas are firing in Ukraine, and the response from the West illustrates the difficulties of getting consensus among allies with different strategic and economic interests in the region. Russia seems willing to test the resolve of Western allies and ready to endure the costs of economic sanctions. At the same time, the government in Kiev is becoming increasingly frustrated by the lack of military support from the West. The economic situation in Ukraine and Russia is bound to deteriorate further in 2015, and the chances that the current proxy war may escalate into a broader confrontation are increasing.

The Syriza victory in Greece adds to the complexity of the political environment in Europe and may lead to an explosive confrontation within the eurozone. Talks about a "Grexit" are again gaining traction as the new Greek government seems ready to push the envelope in its negotiations with the "troika" of the ECB, European Commission and the International Monetary Fund. Greece is hinting that it is willing to let the bailout program lapse at the end of February and that it will no longer abide by its conditions. This game of chicken may end badly as it can spark a run on Greek banks and make Grexit a self-fulfilling prophecy.

Greece seems to be misreading the position of key eurozone partners. The perception in several European capitals is that the dangers of contagion associated with a Grexit are lower than in 2012 and that the greater danger is suddenly rewriting the rules of the game of debt restructuring to accommodate Greece. Concessions may be negotiated, such as reprofiling Greece's debt to extend its maturity further. But markets may not wait to find out if this is possible against the upcoming deadlines.

In sum, we are playing Russian roulette with loaded bazookas. Economic and financial volatility is here to stay, central banks will become less able to influence markets, and geopolitical variables add to the explosive mix. I remain convinced that we can avoid a global recession in 2015 on the current strength of the US and China, the world's two largest economies. But needless to say, my forecast mixes simple calculations based on economic trends with the hope that the concerns enumerated above do not become realities.

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