The best recipe for avoiding a global recession | Economists’ Forum

By Jeffrey Sachs

Before our political leaders get too fancy remaking capitalism next month at the Bretton Woods II summit in Washington, they should attend to urgent business. Since the closure of Lehman Brothers triggered a global banking panic, political leaders in the US and Europe have successfully thrown a cordon round their banks to prevent financial meltdown. What they have not done yet is to co-ordinate macroeconomic policies to stop a steep global downturn. This is the urgent agenda.

A US downturn will not be avoided. US households cannot continue to spend more than their income as they have in recent years, even if the credit crunch eases. Household consumption is bound to fall steeply. The writedowns in US household wealth from the reversals in housing and equities will probably reach $15,000bn (€12,000bn, £9,700bn) and the resulting steep decline in private consumption and investment could reach about one-tenth of that amount.

Some other economies will also suffer home-grown recessions because they too allowed a housing bubble to develop, which has now burst. This appears to be the case in Australia, the UK, Ireland and perhaps Spain. This drop in spending outside the US because of capital losses and reversals in housing may add another $300bn-$500bn to first-round decline in global demand.

Yet even a steep recession in the US and in a few other countries need not throw the world into recession. The world economy is about $60,000bn, so a first-round demand decline of as much as $1,800bn would be about 3 per cent of world output. If there were no offsetting macroeconomic policy changes, the demand decline could be multiplied further to as much as 6 per cent, relative to 4 per cent trend growth, meaning a global decline of about 2 per cent.

On the other hand, even a 3 per cent global demand decline can be substantially offset by expansionary policies, undertaken by the surplus economies of Asia and the Middle East. Ironically, until recently China had been pursuing monetary and fiscal tightening to fight inflation. Now China must make a policy U-turn, to boost its internal demand and support a co-ordinated expansion throughout east Asia.

Any co-ordinated expansion should include the following actions. First, the US Federal Reserve, the European Central Bank and the Bank of Japan should extend swap lines to all main emerging markets, including Brazil, Hungary, Poland and Turkey, to prevent a drain of reserves.

Second, the International Monetary Fund should extend low-conditionality loans to all countries that request it, starting with Pakistan.

Third, the US and European central banks and bank regulators should work with their big banks to discourage them from abruptly withdrawing credit lines from overseas operations. Spain has a role to play with its banks in Latin America.

Fourth, China, Japan and South Korea should undertake a co-ordinated macroeconomic expansion. In China, this would mean raising spending on public housing and infrastructure. In Japan, this would mean a boost in infrastructure but also in loans to developing nations in Asia and Africa to finance
projects built by Japanese and local companies. Development financing can be a powerful macroeconomic stabiliser. China, Japan and South Korea should work with other regional central banks to bolster expansionary policies backed by government-to-government loans.

Fifth, the Middle East, flush with cash, should fund investment projects in emerging markets and low-income countries. Moreover, it should keep up domestic spending despite a fall in oil prices. Indeed, the faster a global macroeconomic expansion is in place the sooner oil prices will recover.

Sixth, the US and Europe should expand export credits for low and middle-income developing countries, not only to meet their unfulfilled aid promises but also as a counter-cyclical stimulus. It would be a tragedy for big infrastructure companies to suffer when the developing world is crying out for infrastructure investment.

Finally, there is scope for expansionary fiscal policy in the US and Europe, despite large budget deficits. The US expansion should focus on infrastructure and transfers to cash-strapped state governments, not tax cuts. This package will not stop a recession in the US and parts of Europe, but could stop a recession in Asia and the developing countries. At the least it would put a floor on the global contraction that is rapidly gaining strength.

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