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Problems *Everywhere*

The risks to the world economy.

When the International Monetary Fund dialed down its forecast for world economic growth this year in January, Maurice Obstfeld, the Fund's new research director, emphasized that it was because of problems pretty much everywhere. Growth of 3.4 percent is still expected, up from an estimated 3.1 percent last year, but the risks "remain tilted to the downside," the IMF announcement said.

Those risks include a generalized slowdown in emerging market countries; China's uncertain effort to move its economy toward more consumption and away from investment in industry and infrastructure; the near-collapse of many commodity prices; and, finally, the Federal Reserve plans to raise interest rates in the United States.

In a very real sense, the interactions among these forces is globalization hard at work. Collectively, they pose a serious challenge for policymakers all over the world. Chinese leaders seem torn over whether to accept as unavoidable the pain of lost jobs and derelict factories associated with shifting the focus of their economy toward consumption, or to keep taking *ad hoc* actions that interfere with markets to ease that pain. As a consequence, there has been a huge capital outflow, and many observers are questioning whether Chinese growth has faltered much more than official statistics show.

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Meanwhile, in many oil-producing countries—and U.S. states, for that matter—the plunge in oil prices has made hash of government budgets. For example, in war-torn Iraq, the loss of oil revenues may leave the government unable to pay employee salaries. The state of Oklahoma is facing a "revenue failure" that would require automatic across-the-board spending cuts by many agencies. Alaska is probably the hardest hit state by far. In Russia, government pensions and a wide range of spending programs may be cut. Mexico, Brazil, Ecuador, Columbia, and Venezuela are all hurting, with the latter a near basket case because of government mismanagement of economic policy.

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And virtually everywhere, of course, investment in oil production facilities is collapsing along with prices.

Naturally, oil consumers are benefiting, for example, from the falling price of gasoline at filling station pumps. But for a variety of reasons, those savings have not so far been reflected fully in increased spending for other goods and services. In Europe, most of the cost of motor fuel is due to taxes, not oil costs, and in the United States, the offsetting cuts in oil patch investments and resulting job losses have been significant.

The risks cited by the IMF, particularly the Chinese situation, have caused increased market volatility all over the world. That market turmoil, including sharp declines in equity prices, probably had little impact on the Fed's Federal Open Market Committee decision to leave its target for overnight interest rates unchanged at 0.25 to 0.5 percent when it met in late January. After it increased that target for the first time in eight years in December, no one expected more so soon. However, some analysts who had been expecting another rate in increase in March began to talk about June instead.

A week after the meeting, Fed Vice Chairman Stanley Fischer told a New York audience that the recent "further declines in oil prices and increases in the foreign exchange value of the dollar suggested that inflation would likely remain low for somewhat longer than had been previously expected before moving back to 2 percent [the Fed's goal]. In addition, increased concern about the global outlook, particularly the ongoing structural adjustments in China and the effects of the declines in the prices of oil and other commodities on commodity-exporting nations, appeared early this year to have triggered volatility in global asset markets."

Fischer said that volatility might or might not lead to "a persistent tightening of financial conditions," but then he said, "they could signal a slowing in the global economy that could affect growth and inflation in the United States." On the other hand, he added, similar periods in the past "have left little permanent impact on the economy."

Fed Chair Janet L. Yellen, in her semi-annual monetary policy report to Congress in early February, also acknowledged the risks to U.S. growth from the turmoil. Low and falling commodity prices could trigger "financial stresses," she said, that might damage foreign economic activity, weaken demand for U.S. exports, and cause financial markets worldwide to tighten further.

Examples of such stresses abound. In this country there is a growing likelihood of a wave of bankruptcies among smaller oil companies, and stock prices of large international banks are weakening as investors anticipate large losses on loans related to oil investments.

If things do go substantially awry in the world economy, it's clear that most countries are not in a position to try to stimulate their economies using fiscal policy. In Europe, where growth has been seriously lagging for years, tax cuts or added spending have been off the table while Germany has demanded austerity instead. So the European Central Bank has been the only game in town. ECB President Mario Draghi pushed for and got a quantitative easing program that has done little to stimulate growth, partly because of a persistently undercapitalized banking system. Recently, he has talked about additional steps but with no details. One possibility is lowering even further the already-negative interest rate the ECB charges banks on cash deposited with the central bank overnight. Making the rate more negative might give banks a greater incentive to lend the cash to customers. On the other hand, it could instead encourage additional capital outflows from the eurozone and cause the value of the euro to fall relative to the dollar.

The Bank of Japan, faced with an even more fraught economic situation, decided at the end of January to follow in the ECB's footsteps by moving to negative interest

Investment in oil production facilities is collapsing.

rates, too. The Bank of Japan had already reached the limits in its own quantitative easing program. The objective is to push banks to lend their excess reserves to borrowers rather than deposit them with the Bank of Japan. It is doubtful it will work given the lack of overall demand in the Japanese economy.

Being a "systemically important financial institution" is not a blessing.

These developments underscore how little ammunition governments have to spur economic activity. Major central bank interest rate targets are not much above zero. The Fed's is a measly twenty-five basis points effective above the so-called zero lower bound, so that's how much it could cut in response to a widespread economic slowdown. Moreover, there is significant political opposition essentially to the Fed taking any actions at all. Several of the Republican presidential candidates talk favorably about returning to a gold standard, as does the chairman of the tax-writing House Ways and Means Committee. The GOP candidates mostly propose major tax cuts, with the revenue loss offset by faster economic growth, they claim. On the Democratic side, there are proposals for both tax cuts and increases.

In an election year, of course, with a Republican-controlled Congress and a Democrat in the White House, no one's proposals are going to become law whatever happens to the world economy.

On another level, the Fed is making considerable progress, though you would not know it from the comments by most of the presidential candidates. The GOP group generally denounce reforms put in place by the Dodd-Frank financial reform legislation. A major call by Sen. Bernie Sanders, the independent from Vermont who caucuses with the Democrats and is seeking that party's presidential nomination, is to strip Wall Street of its power. Some of the biggest banks might or might not truly be too big to fail, but studies have shown that the funding advantage they used to have because investors believed they were indeed too big to fail has vanished. Their capital requirements are in the process of being raised to the point that being a "systemically important financial institution" is not a blessing.

Eight years ago the United States, indeed the world, was on the brink of what became known as the Great Recession. A Federal Reserve chairman and a Treasury secretary generally cooperated in trying to find ways to deal with unprecedented events in financial markets during a presidential election year. The incumbent president was not running for reelection and was not focused on scoring political points. The Republican nominee, Sen. John McCain of Arizona, was curiously detached from the policymaking process. The Democratic nominee, Barack Obama, also generally let the incumbent officials craft the policy responses.

Would this year's yet-to-be-chosen nominees also stand aside if another crisis were to develop? Should another risk be added to the obvious ones on Obstfeld's list?

Carl Weinberg, chief economist at High Frequency Economics, is a bit of a Cassandra, but he has his reasons. He wrote in January, "When you start to talk about commodity price declines as the basis for nervousness about the global economy, on a scale big enough to trigger a global equity market downturn, you have our attention. We have focused on the link between the drop in world trade value, the loss of income—nominal and real—in commodity-exporting countries, and the risks to global GDP. We have argued that a substantial loss of income as export prices fall forces commodity exporting emerging economies to cut imports from advanced economies, reducing GDP levels and growth rates … The drop in commodity prices booked in 2015 is the largest in percentage terms in the last half-century. You have to go back to 1949 and 1952 to find a bigger decline."

The stress in oil-exporting nations is getting worse.

The stress in oil-exporting nations is getting worse. In early February, the credit ratings of half dozen of them were downgraded, and Nigeria, the largest oil producer in Africa, asked for financial assistance from the World Bank and the African Development Bank. A number of analysts have concluded that the oil glut is likely to last for at least another two years, with demand weak and more production coming on line as Iranian sanctions are eased and its sales gradually resumed. And it is abundantly clear that members of the Organization of Petroleum Exporting Countries have no appetite for a cooperative reduction in output.

So there's ample reason for Obstfeld and his IMF colleagues to say there are downside risks to their modest forecast for 2016. The scary prospect is that if that forecast proves to be much too optimistic, policymakers may not be able to do much in response to the bad news. ◆