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Opinions

Why the Fed needs to prepare for the worst right now

By Lawrence Summers January 10 at 8:18 PM

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Often markets are volatile at the end of the year — as many traders go on holiday and those with losses unload them — and then settle down as a new year begins. Not this year. U.S. and European markets closed significantly lower on Friday after a very rough week despite a very strong U.S. jobs report. The week's economic news was dominated by dramatic declines in China's stock market and currency; the week also saw a further plunge in oil prices even in the face of major tension between Iran and Saudi Arabia.

A week when bad market news repeatedly makes the front page raises the general question of how much forecasters and policymakers should look to speculative markets as indicators regarding future prospects. And it raises the more specific question of how alarmed policymakers should be about the prospect of a global slowdown, especially in light of the financial dramas playing out in China.

There is little question that markets are highly volatile relative to the fundamentals they seek to assess. Economist Paul Samuelson famously quipped 50 years ago, "the stock market has predicted nine of the last five recessions." Former Treasury secretary Robert Rubin was right when he would regularly reassure anxious politicos in the Clinton White House that "markets go up, and markets go down" on days when a market move created either joy or anxiety. The best executives manage their company with an eye to long-run profitability, not daily stock price. And policymakers do best when they concentrate on strengthening economic fundamentals rather than on daily market fluctuations.

At the same time, because markets aggregate the views of a huge number of participants, and because they are constantly assessing the future (unlike economic statistics, which only reflect the past), they are like canaries in coal mines: very valuable in giving warning when conditions change. That is why several studies have shown that prediction markets do a better job of forecasting elections than pollsters and why Hollywood studios use such markets to judge the likely success of movies.

Policymakers who dismiss market moves as reflecting mere speculation often make a serious mistake. Markets were on to the gravity of the 2008 crisis well before the Federal Reserve was; to the unsustainability of fixed exchange rates in Britain, Mexico and Brazil while the authorities were still in denial; and to the onset of a slowdown or recession well before forecasters in countless downturns.

While markets do sometimes send false alarms and should not be slavishly followed, the conventional wisdom essentially never recognizes gathering storms. The Economist reports this week that, looking across all major countries over the past several decades, there were 220 instances in which a year of positive growth was followed by one of contraction. In its April forecasts during the growth year, the International Monetary Fund did not anticipate a coming recession on a single occasion!

Market signals should be taken especially seriously when they are long-lasting and coming from many markets, as is the case with current indications that inflation will not reach target levels within a decade in the United States, Europe or Japan. Especially ominous are moments when news fails to rally markets as would be expected such as with the U.S. stock market and Friday's strong employment report or the decline of oil prices in the face of heightened Middle East tensions.

Last week we saw huge negative movements in Chinese markets and a large foreign market response. While it certainly could be the case that the Chinese developments reflect a combination of market psychology and clumsy policy responses, and that the strong response of world markets is an example of transient contagion, I doubt it.

Over the past year, about 20 percent of China's growth as reported in its official statistics has come from its financial-services sector, which has mushroomed to the point where it is about as large relative to national GDP as in Britain, and Chinese debt levels are extraordinarily high. This is hardly a case of healthy or sustainable growth.

In recent years, China's growth has come heavily from massive infrastructure investment; indeed, China put in place more cement and concrete between 2011 and 2013 than the United States did in the whole of the 20th century. This growth, too, is unsustainable, and even if it is replaced by domestic services, China's contribution to demand for global commodities will fall way off.

Experience suggests that the best indicators of a country's economic prospects are the decisions that its citizens make about keeping capital at home or exporting it abroad. The reason the renminbi is under pressure is that Chinese citizens are extremely eager to move their money overseas. But for the substantial recent depletion of China's reserves, the renminbi would already have substantially depreciated.

Traditionally, international developments have had only a limited impact on the U.S. and European economies because their impact could be offset by monetary policy actions. Thus, the U.S. economy grew robustly through the Asian financial crisis as the Fed brought interest rates down. With rates essentially at zero in the industrial countries, however, this option is no longer available, and foreign economic problems are likely to have much more direct effects on economic performance.

Because of China's scale, its potential volatility and the limited room for conventional monetary maneuvers, the global risk to domestic economic performance in the United States, Europe and many emerging markets is as great as any time I can remember. It is time for policymakers to hope for the best and plan for the worst.

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