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Watering the green shoots

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The global economy appears to be clawing its way out of the fiercest recession in decades. Numerous green shoots of recovery suggest that the second quarter of this year will mark the turn of the cycle. The forces behind this turnaround have been evident for some time: Fiscal injections, aggressive monetary policies, huge bank rescue packages and, on top of all that, an unprecedented slide in commodity prices which has pushed inflation down and boosted real private household incomes in many countries.

A sober diagnosis of events also points to an imminent recovery. What we have experienced is a sudden and massive negative demand shock, triggered by uncertainty and angst among market participants following the unexpected escalation of the financial crisis. The blow to confidence, or the "fear factor", was exacerbated by the concern that the erosion of financial wealth due to the market downturn and the necessary curtailment of private debt could seriously undermine private consumption demand. This created a potential noxious mix of structural and cyclical problems. In an attempt to restore confidence and compensate for the fall in private demand, Keynesian policies were warranted. And, no surprise, in a Keynesian situation, these are proving effective. Business expectations have been perking up, as the biggest threats like the collapse of the global banking system or an unbroken downward spiral in the world economy, started to fade. The question is how swift and strong such an upward correction will be. Indeed, taking former recessions as a benchmark, cyclical rebounds can be quite forceful. In normal recessions, the return to production levels before the crisis takes about the same time as the downturn itself. Of course this is no run-of-the-mill recession, but a devastating financial crisis. Therefore, even under optimistic assumptions, a return to pre-crisis production levels looks set to take at least two to three years.

Furthermore, with unemployment and insolvencies rising, early phases of economic recovery are fragile. Adverse shocks, such as sudden commodity price spikes or ugly headlines about slumbering banking risks, can easily derail the recovery and lead to a double-dip recession pattern. A prolonged recession has to be avoided. Otherwise, as we witnessed in the major recessions of the seventies and eighties, cyclical problems can become structurally entrenched. High unemployment brings the risk of dequalification and demotivation in the workforce, effects which can perpetuate the unemployment problem. Furthermore, in a long recession, companies will substantially trim their medium-term investment and growth plans and therefore reduce their capital accumulation for many years. Therefore, despite the risks posed to long-term development by ballooning public debt and strong money growth, a premature termination of expansionary demand policies could prove dangerous. As things stand, early fiscal or monetary contraction does not seem very probable. Indeed, many governments are still discussing the need for further stimulus packages.

This means we are at a critical juncture. The tender green shoots need watering to prevent them from withering and dying before they can take hold. The unprecedented stimulus packages around the globe have thrown the kitchen sink at the problem of stalled demand in a bid to resuscitate growth. But beyond that, governments face the challenge of improving the conditions for medium-term growth – no easy task at a time of rampant public scepticism about the benefits of market forces, liberal and open markets, and more international competition. Policy efforts will probably focus on improving education and qualification. But tax policies can also bolster medium-term growth. In Germany, for example, there is a case for reducing the relatively higher burden on equity financing over debt financing inherent in the corporate tax regime and for correcting the comparatively punitive taxation of lower and medium incomes that has just recently been highlighted again by the OECD. Such reforms would not only increase demand in the short term. They would also strengthen the economy in terms of equity capital and labour supply incentives and thereby help to generate sustainable medium-term demand growth – a must, especially in surplus countries like Germany. More medium-term growth implies higher medium-term tax revenues. Delaying such reforms until budgets are in better shape could mean postponing them into the distant future. That would be too late.