

The risk of global economic meltdown

June 17th, 2009

Posted by: [Felix Salmon](#)

[Mohamed El-Erian](#) has some imperatives for governments in general, and the US government in particular:

Policymakers face three distinct challenges... First, their market interventions must be accompanied by a clear notion of when and how they will get out. Second, they must manage their involvement with an eye on minimizing disruptions to the normal functioning of markets and incentives. Third, they must be able to identify and address the adverse unintended consequences of their actions...

Policymakers must find a way to upgrade their liability management approaches consistent with the paradigm shift in the public finance area. They must also credibly signal their intention to return to longer-term fiscal sustainability through the generation of meaningful primary budgetary surpluses.

That's five "must"s there, zero of which are going to happen. Which is one reason why, if the current phase of the economic crisis is a function of financial-market failure, the next phase of the economic crisis is going to be a function of government failure, at every level from the municipal, up through federal fiscal and monetary policy, to the level of international economic coordination and cooperation.

There's no doubt that some countries will bear more of the brunt than others — I wouldn't want to be Italy right now, for instance, with its dysfunctional government, its massive exposure to toxic eastern European assets, and its status as the most likely country to be forced to leave the euro, default and devalue. But the global economy is so interconnected that no one will be protected from the effects of these failures around the world.

Nouriel Roubini [came in to Reuters](#) this morning and talked about the way in which the stock-market and credit-market rally since the lows of March was partly (but not entirely) a function of the fact that tail risk has genuinely diminished: the probability of a second Depression is lower now than it was in March. There's truth to that, but (and I never thought I'd say this) Nouriel might be being too sanguine here.

In March, markets were worried that the fierce left jab of global financial failure would deliver a resounding KO to the world economy. It's now clear that didn't happen, although all global economies have suffered some extremely nasty bruises, and some, like Iceland, really were knocked out entirely. The problem is that none of the markets are remotely pricing in the risk of the right hook of *government* failure — something which we're beginning to see with things like Angela Merkel's [remarks](#) on monetary policy or the Obama administration's [inability](#) to push climate-change legislation, or root-and-branch regulatory reform legislation, or even a financial-institutions rescue package, through Congress. ([Hence](#) the need for horrible creatures like PPIP instead, which don't need Congressional approval.)

One of Nouriel's other points was that it's going to be extremely difficult for Ben Bernanke and the FOMC to walk the tightrope between raising rates too slowly and raising rates too quickly: the former causes inflation and mistrust in government institutions, while the latter could send GDP growth straight back into negative territory. My gut feeling is that there *is* no tightrope to be walked, and that even with some Platonically perfect monetary policy we're probably going to end up with some combination of the two outcomes. I believe the term of art is stagflation. And that's just the beginning of what could go wrong as a result of government actions around the world.

My view, then, is that tail risk is as big as ever, and that world markets are in something of a state of denial about it. Maybe economic armageddon isn't quite as terrifyingly incipient as it was in March. But it's still a real possibility. And it isn't priced in.

<http://blogs.reuters.com/felix-salmon/2009/06/17/the-risk-of-global-economic-meltdown/>