THE WORRISOME COST OF WORRYING ABOUT RECESSION

The global economy has been hit by multiple shocks this year: new Covid-19 cases in China, the war in Ukraine, rising interest rates. Financial market behaviour and the US Survey of Professional Forecasters point to mounting concerns about the risk of a recession. These worries come with a cost to the economy and may cause growth to slow down further. Some degree of concern is welcome because it enhances the effectiveness of a restrictive monetary policy. There is a tipping point however, beyond which slowdown fears become self-fulfilling. Addressing these would be difficult if by then inflation has not yet converged sufficiently to target.

Recession worries are mounting. In the US, the anxious index – the probability estimated by the Survey of Professional Forecasters of entering recession in the next quarter – has increased recently (chart 1). Media increasingly use the 'R-word' and prices of equities and corporate bonds have declined, suffering from rising interest rates and a jump in investor risk aversion. These developments don't come as a surprise. After all, the global economy has been hit by multiple shocks this year: drastic restrictions on mobility in China following the increase of new Covid-19 cases, the war in Ukraine, which has intensified supply disruption and caused a further increase in commodity prices as well as a jump in uncertainty. Moreover, in many countries, monetary policy has been tightened and more is to come. Rising concerns do not imply that a recession is inevitable. After all, in the past, equity and corporate bond markets have often provided false signals and the same applies to the anxious index.

However, these recession worries come with a cost, which is worrisome. Companies may prefer to adopt a wait-and-see attitude and refrain from increasing their headcount. This entails an opportunity cost for people who didn't get a job and hence remain unemployed or who couldn't move to a higher paid role. As a consequence, households may adopt a more cautious stance and increase their precautionary savings. Companies may also postpone investment decisions. This implies a reduction in shareholder value creation because projects with a positive net present value are put on hold.

The microeconomic rationale underpinning such behaviour may make perfect sense. The purpose of tightening monetary policy is to slow growth enough to bring inflation back under control. This forces companies to revise downwards their expected cash-flows. Moreover, the distribution around the median scenario widens -reflecting greater uncertainty – and becomes skewed because downside risks dominate. Tail risk – i.e. a recession – also increases. In such an environment, managers become more risk averse although they may still be confident about the medium-term outlook. They consider there is value in waiting before proceeding with planned investments, which would happen when visibility has improved.

To some degree, managerial short-term caution reflects agency problems. Managers, as agents of the shareholders – the principal – are worried of being blamed for not having shown greater caution in the run-up to a recession. Principal-agent problems may thus contribute to a growth slowdown. Similar problems exist when companies rely on external financing sources such as banks and capital markets to finance part of their investments.

Slower growth raises concern about rising credit risk, causing banks and financial markets investors to adopt a more cautious stance. This is based on the historical experience that growth and credit risk are negatively correlated. It also reflects an issue of asymmetric information between borrowers and lenders.[1] The higher financing

1. There is a potential divergence of interest between borrowers and suppliers of financing. When growth slows down, net worth of borrowers may decline, so they have less to lose when undertaking risky projects. Lenders must incur higher costs to analyse the credit quality of the borrower. Both factors cause an increase in the financing cost of borrowers.

US ANXIOUS INDEX

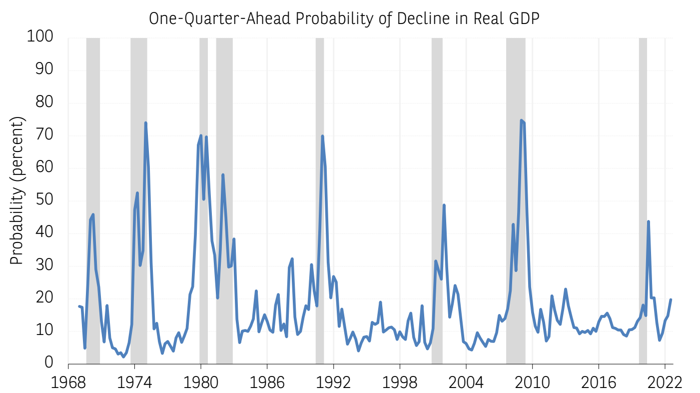

CHART 1

SOURCE: SURVEY OF PROFESSIONAL FORECASTERS, FEDERAL RESERVE OF PHILADELPHIA

> Worrying about a recession comes with a cost for the economy. This enhances the effectiveness of a tightening of monetary policy but there is a tipping point beyond which slowdown fears become self-fulfilling.

costs (chart 2) have an immediate impact - lower profitability due to higher interest charges - but may also weigh on the willingness or ability of companies to invest. Agency problems again play a key role. Managers of corporate bond funds (the agents) will worry about underperforming their peers by not reducing their risk exposure when the latter have done so. When performance is lagging the competition, asset managers may face redemptions by their clients (the principal).[2]

It is worrisome when people increasingly worry about recession risks because it comes with a cost for the economy. This may even strengthen the belief that it was appropriate to be concerned. It can be argued that some degree of concern is welcome because, by weighing on the growth outlook, it is a transmission channel of a restrictive monetary policy. There is a tipping point however, beyond which slowdown fears become self-fulfilling. Addressing these would be difficult if by then inflation has not yet converged sufficiently to target.

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US: HIGH YIELD CORPORATE BONDS AND SPREAD OVER TREASURIES

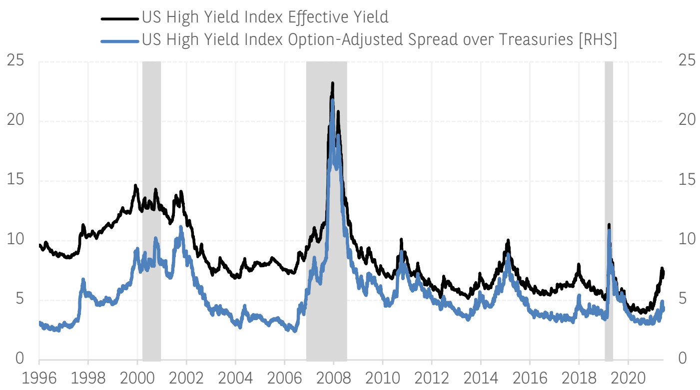

CHART 2 SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS, BNP PARIBAS

This phenomenon is called the financial accelerator. Source: Ben Bernanke, Mark Gertler and Simon Gilchrist, 'The financial accelerator in a quantitative business cycle framework', NBER working paper 6455, 1998.

2. Asset owners such as insurance companies who manage their own assets will also show a lower risk appetite, having in mind that they must report to their board.