The Risk of Prolonged Stagnation and the Need for International Concerted Action

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A Worrisome Scenario for the Global Economy: A Massive Growth Slowdown

The prospects for the global economy have been significantly downgraded since the summer of 2011, especially for advanced economies. International organizations such as the International Monetary Fund and Organization for Economic Cooperation and Development now forecast gloomier outlooks for the world economy and anticipate a baseline scenario of renewed slowdown in the U.S. and Europe for the end of 2011 and beginning of 2012. In the best scenario for the global economy, the growth rate is so below potential that there is a significant increase in the unemployment rate. The other scenario, which has a 50 percent probability, is much worse; it is one of recession with an economic contraction in all advanced economies in the next two quarters.

Another reliable indicator also points to the very high risk of a global recession: the 10-year German Bund and the U.S. 10-year Treasury bond yields have fallen significantly due to a sudden rush to move investments into what are considered "safe" assets.

For emerging market economies, the gloomy economic outlook for advanced economies implies an economic slowdown and a partial recoupling of their growth rate with those of the U.S. and Europe. However, it is going to be more problematic in some economies, like emerging Europe, than in others, such as East Asia and notably China.

How did we get here? By spring 2009, thanks to a massive global monetary and fiscal stimulus coordinated by the G-20, a partial recovery started and a global depression was successfully avoided. The first signs of recovery were seen in financial markets, but soon extended to the real economy as inventories were rebuilt. As the dynamics of recovery acquired greater strength, many were confident in a relay race between public expenditure and private spending so to strengthen and consolidate the ongoing global recovery. According to the OECD and IMF, this scenario already materialized in the first part of 2011.

But this was not the case. Once the fiscal stimulus slowed down in many advanced economies, growth started slowing down as well. The anemic output recovery did not involve any significant pick-up of private expenditure in the most advanced areas, notably in the United States. Companies and households remained cautious about spending. Growth in U.S. consumer spending over the two last years has been lower than those in all previous recoveries since World War II. With consumer demand still accounting for 71 percent of real U.S. GDP, a protracted slowdown in consumption has hurt overall U.S. economic growth. In addition, there was no significant increase of private investment with American firms preferring to hoard cash.

The Weak Recovery: Both a Result and Cause of Ongoing Depressed Aggregate Demand

It is quite clear that the effects of the global economic crisis are far from over and that the world economy still faces serious uncertainty in its short- and medium-term growth prospects. The reasons for this are found in both demand and supply factors. Since no other economy is capable of compensating for a protracted shortfall in U.S. consumption, the global economic slowdown is being felt across the board. Countries end up reinforcing each other, notably export-led growth Europe and Japan. Domestic consumption in emerging economies is still too modest so the enduring weakness in U.S. consumption, and thus the ongoing weakness of global aggregate demand, has been stifling global economic growth.

The Great Recession was not a typical recession, where economies do often grow much faster than usual during the first 12 months of the recovery. This recession is first of all defined by a financial crisis and excess of debt at all levels, including households, banks and governments. Almost all advanced economies are badly overleveraged and in such conditions traditional policy tools used to sustain aggregate demand through expansionary fiscal or monetary policy are only able to make limited positive impacts.

Previous massive fiscal stimulus has largely failed not because it was not large enough but because it crashed against too much debt at all levels. Over-indebted households in advanced countries, most notably in the U.S., have been forced to cut back and rebuild their damaged balance sheets by paying down outsize debt burdens and rebuilding depleted savings. This balance sheet repair has only just begun and everything suggests that it will continue for many years to come. The painful ongoing process of deleveraging implies that economic growth could remain below trend for many years until the deleverage has occurred. It follows that the depth of contraction and the weakness of the recovery are a both result and cause of the ongoing depressed aggregate demand at the domestic and international level.

Problems in the Supply Side

But there are problems at the supply side level as well. OECD estimates indicate that potential output level in the advanced economies may have decreased by as much as 3 percent as a consequence of the Great Recession. While potential growth is more difficult to pin down, it is likely that it has also been affected. The same OECD estimates indicate that average potential growth in the OECD areas may have been cut down by as much as 0.5 to 1 percent.

This is a result of a number of factors. First, the recession has significantly increased structural unemployment (or, in some cases, it has significantly increased the duration of unemployment) and has generated destruction of capital stock in several countries. In these cases, there may be loss in embodied knowledge and consequent negative impact on productivity. Second, total factor productivity may have been affected as a result of, for example, the closure of several companies and the loss of their stock of knowledge. Third, the rapid growth of the new emerging market economies, like China, has led to the loss of low-skilled manufacturing jobs in advanced economies and new investments in large industrial sectors were only temporarily replaced by housing construction, which was sustained by low interest rates and huge deregulation.

Therefore to sustain and consolidate a recovery, it is not enough to just produce more of what used to be profitable pre-crisis. Firms should instead anticipate what will be profitable to produce in the future. Potential output levels will be lower but its composition is bound to be different as a number of companies will have been thrown out of business. Taking potential output back to its pre-crisis levels, and even more importantly boosting the rate of growth of output, will require not just supporting household consumption and business investment but producing an effort in reallocating resources toward new products and sectors. In other words, in order to leave behind the consequences of the Great Recession, all advanced economies will have to pursue "new sources of growth".

A Combination of Keynesian and Schumpeterian Policies to Reduce the Risks of a Severe Economic Downturn

If the diagnosis above is correct, it means that to avoid a severe contraction that could turn into a

Japanese style long-term depression, advanced economies need to implement a new growth strategy that is able to tackle both the lack of demand and supply deficit. They should implement policies to offset deficient aggregate demand and supply since the reasons for high unemployment and low growth are not only short term but structural as well. All that by fulfilling the new and more stringent constraints arising from the needed consolidation of public debt. The traditional demand management policies and pure supply-side economics are both inadequate and there is a need for a policy somewhere between the two. In other words, the huge challenge is how to implement simultaneously a sort of mix of Keynesian demand and Schumpeterian supply side policies.

As for the issue of ongoing depressed aggregate demand, there is no doubt that policymakers should avert generalized fiscal austerity and provide additional short-term stimulus since quantitative easing could help but is not enough. The present fiscal austerity measures applied on a large scale are determining recessionary effects on output in the advanced economies. This is even more so the case with the lack of aggregate demand at the global level given the deleveraging of households and governments and the glut of capacity due to the massive overcapacity in China and in other Asian countries. This is particularly true in the eurozone where the ongoing austerity measures will ultimately hinder growth, especially in in the most distressed economies like Greece. In turn, low growth in Europe will hurt tax revenues, which undermines the proclaimed goal of fiscal consolidation.

Although highly indebted countries, such as those in the eurozone's periphery, should continue to undertake fiscal austerity, there are other countries—such as the U.S., Germany, the U.K., China and Japan—that can provide fiscal stimulus in the short run by postponing their own fiscal discipline adjustments. In addition, it is vital to continue to provide liquidity to illiquid but solvent sovereigns and restructure unsustainable private and public debts in an orderly manner.

In this regard, one should note that the coordination of macroeconomic policies at the G-20 level has a crucial role to play. In a new multipolar world economy, support for aggregate effective demand assumes all the contours of a public good in the sense that macroeconomic cooperation is not only desirable but somehow necessary for producing expansionary global demand and for avoiding countries' free riding in the system.

The Key Role for International Macroeconomic Policy Coordination

The path to recovery and stable growth today lies not in a new consumer bubble but in new infrastructure, upgraded skills and low-carbon energy (structural policies). It follows that fiscal stimulus measures should not be wasted by simply increasing current public expenditure and/or by tax cuts to revive debt-burdened consumers in advanced countries, notably in the U.S. Countercyclical fiscal interventions should be targeted to new areas of growth, such as tangible and intangible infrastructures, education, job-training and human capital improvements, and alternative and renewable energies. To justify these interventions one could emphasize not only the traditional Keynesian argument, emphasizing short run demand effects but also long run Schumpeterian growth effects working primarily through the supply side of the economy. Besides, most of these productive government investments need not add to net financial liabilities if they are repaid through future revenues, especially if they are able to stimulate additional private investments through new incentives. In a sovereign debt crisis, the key issue is how to raise new resources for medium- and long-term investment for growth as well as enhancing a new legal framework for project bonds, debt instruments and more generally credit-enhancing initiatives. Currently, budget accounting in the U.S. and Europe fails to distinguish between self-financing capital projects and those financed by general revenues. If successful, new financial instruments will be an interesting long-term investment opportunity for private institutional investors, such as pension funds, insurance companies and households.

These supply side measures depend more closely on domestic structures and national policies autonomously formulated by individual countries, but in the present highly interdependent oligopolistic system their implementation is also more closely dependent on the international coordination to avoid any collective action problems mentioned above.

The Very Narrow Path to Global Growth and the Risk of Prolonged Stagnation

One should recognize that the single most important driver of fiscal consolidation in countries is strong tax revenues, owing to their good economic performances. The appropriate response for advanced economies would be to put their economies back toward growth.

However, in the current phase, markets cannot generate a fast demand recovery by themselves, since the weaker the expected growth in demand is, the smaller the desire of companies to invest; while they cannot generate structural adjustment as well until a demand recovery is going to consolidate. Therefore, the ongoing slowdown and simultaneous collapse of market confidence in the U.S. and eurozone is sort of a trap. We are stuck in this trap today and we need to find a way out. It will not be easy because there are so far no signs of economic policies in the direction of the ones advocated above.

Neither the U.S. nor Europe has even properly diagnosed the core problem. Obama's disappointing strategy was to try to revive America's over-consumption through a series of tax cuts, increases in government spending and a flood of liquidity from the Federal Reserve Board. The eurozone—with its sovereign debt problems spreading beyond Greece, Ireland and Portugal to Italy, Spain and others, and with significant problems in its banking system—keeps pursuing a self-defeating austerity package without a vision for medium- and long-term investments. It is no wonder that the eurozone is causing major turbulence in the global economy today.

The face that the U.S. and the eurozone have no growth strategy is a great cause for worry. The recent turmoil in financial markets and the stalled recovery in the U.S. and Europe reflect these fundamental shortcomings. The path to recovery and stable growth lies in investing in workers and long-term productivity growth by implementing new policies in advanced economies that deal with the lack of demand and supply deficit at national and international levels. The need for concerted action at the G-20 and international level is greater than ever. A key feature of the new multipolar global economy is that no single country can on its own assure the stability of the international economic system and therefore the advantages of cooperation have been greatly enhanced. This public good characteristic of solutions in a multipolar global economy is applicable to many areas, including trade and finance. However, it is particularly important and relevant to the macroeconomic policies of major countries and the growth of the world economy. A strong coordinated response among G-20 countries is therefore necessary in order to minimize the risk of a mild global economic slowdown or worse another severe prolonged recession. But time is running out so the time for action is now.