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The Gloomy Prospects for World Growth

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INTRODUCTION

The seeds of the current economic and financial crisis were sown by economic policies of the major countries that fostered the growth of global imbalances during the 2000s. Consequently, an essential element in any assessment of prospects for world economic recovery and the pace of future growth has to factor in exactly how these imbalances are likely to unwind—or fail to be resolved—in the period immediately ahead.

Since the onset of the crisis, current account imbalances among the major economies in the world have declined, leading some analysts to think that imbalances were starting to unwind. Unfortunately, however, changes in current account imbalances have largely reflected the effects of the economic downturn. To address the underlying imbalances in savings and investment behavior that continue to exist, major economies will need to make some important changes in economic policies.

Understandably, the focus of economic policy up until now has been on tackling the immediate problems of dealing with major financial disruptions, stabilizing the world's major economies, and trying to restart growth. Any thinking beyond these initial challenges has been directed at addressing the significant failures in regulation and supervision of the financial sector that contributed to the severity of the crisis. Increasingly, light is being seen at the end of the tunnel, the beginnings of economic recovery are being proclaimed, and exit strategies from economic stimulus are being discussed. Some of the stimulus policies that have been pursued will facilitate the adjustment of global imbalances; however, actions in many countries appear likely to add to imbalances over time, and the lack of needed policy actions—especially structural reforms—in other countries will delay adjustment as well.

As a result, the outlook for recovery and growth in the world economy at this juncture appears rather gloomy. Lasting adjustment in imbalances is taking place only in the United States, and this will continue over the medium term. The result will be significantly slower growth in U.S. demand in the next several years. Hence, the main factor determining growth in the world economy will be whether other sources of demand will arise to take up the slack left by slower U.S. growth. At the moment, prospects do not look good. None of the other major economies appear inclined to make the necessary changes in policies to deal with their imbalances and raise their demand. Therefore, the world economy faces the prospect of a prolonged period of slower growth and greater volatility than it has known for several decades.

ADJUSTMENT IN THE UNITED STATES

In the United States, savings in the household sector have risen significantly, and these increases are likely to be permanent. The decline in housing prices has had a major impact on savings behavior. The surge in consumption during the economic expansion in the early 2000s was heavily linked to increases in the value of housing. However, this consumption boom did not reflect a traditional wealth effect; it was predominantly a financing phenomenon. Innovations in financial markets increased access to credit for households by making it very easy for individuals to tap the equity in their homes to fund consumption expenditures. But this source of consumption financing has dried up. With lower house prices, households have less equity in their homes, and with a greater debt burden acquired in the previous expansion, households are and will continue to be reluctant to borrow. Con-

sequently, saving has risen in recent quarters back to its average level during the last economic expansion in the 1990s. At that time, household savings averaged about 5–6 percent of disposable personal income, compared with the near zero average rate recorded during the final years of the economic expansion in the 2000s.

There are considerable reasons to believe, however, that the U.S. household savings rate will rise significantly above its current level. Households have experienced a substantial decline in financial wealth, in addition to the sharp fall in the value of housing. In response to these large losses, households will have to raise savings to rebuild their wealth. This is particularly true for members of the baby boom generation, as this large cohort is fast approaching the traditional age for retirement. Baby boomers now have to face the choice of either significantly raising their savings or postponing retirement. In the early 1990s, the boomers faced a somewhat similar need to increase financial resources for retirement. At that time, they had two basic choices: to save more or to raise the returns on their existing savings. They chose to raise returns on their assets by shifting their portfolios toward higher-yielding equity investments. But now households have already diversified their portfolios heavily into equities, and they have little room to shift them further. Moreover, they have little appetite to do so. Twice in the past decade major stock market corrections have hit household financial wealth hard, making equity investments look a lot more risky than they were perceived to be originally. In these circumstances, the baby boomers are likely to raise their savings significantly.

The U.S. government will also have to increase its savings to deal with the massive fiscal deficit that has opened up, in part owing to the necessary measures that the Obama administration has taken to stabilize the economy. But government savings will also have to rise to deal with the underlying imbalance in the U.S. fiscal position that has existed since the Bush administration embarked on a substantial fiscal expansion in the early 2000s. In order for the U.S. government to be able to meet its obligations to its aging population without having to resort to major increases in taxes or cuts in spending (including programs for the elderly), the budget will have to be brought back into surplus, and that surplus will have to be maintained for some time to cope with the pressures on spending arising from population aging.

The Obama administration recognizes the need for fiscal consolidation. Its budget blueprint, released in early 2009, lays out a credible plan for beginning this process. However, in implementing a substantial fiscal consolidation on the scale of what is needed, the administration will face some very tough choices, especially because the economic and political environment in the period ahead is not likely to be very conducive to fiscal consolidation. Relatively slow economic growth over the next several years will offer a convenient pretext for putting off adjustment. But the administration will have little choice but to proceed anyway or risk creating conditions that will result in persistent slow growth over the medium term.

Somewhat slower growth in the near term arising from fiscal consolidation is a tradeoff that will have to be made to achieve a sustainable budget position and lay the foundation for a return to more rapid growth. Delaying fiscal adjustment would provide only marginally higher rates of growth. Near-term growth would be only marginally higher in the absence of fiscal adjustment because household savings would rise even further as individuals recognize that it will be increasingly likely that either medium-term government promises regarding pension and health care benefits will be broken or that taxes will have to be raised substantially or other government spending cut. A protracted period of large fiscal deficits would also significantly push up real interest rates and reduce investment, in turn reducing growth. So in the end, the Obama administration has only one respon-

sible choice and that is to proceed with fiscal consolidation as economic recovery takes hold in the next one to two years.

Therefore, it can be expected that national savings in the United States will rise substantially in the period ahead. Thus, adjustment in the U.S. savings and investment imbalance will take place, and the current account deficit will narrow. Consequently, demand in the United States over the next decade or so will grow substantially slower than it has in the preceding three decades.

PICKING UP THE SLACK: EUROPE AND JAPAN?

Europe is an unlikely candidate to pick up the slack in world demand resulting from slower U.S. growth. Major European countries—particularly Germany—look likely to remain heavily dependent on exports to drive their economies. This situation reflects in part a sense of complacency among the Europeans and a lack of political will, especially in current circumstances, to implement some difficult, but necessary, policy measures. The complacency of the Europeans arises from their view that they are victims in the current economic and financial crisis. They see little wrong in the economic policies that they have followed. In particular, they argue that they have developed a competitive advantage in the export of certain types of goods, and exploiting this advantage was a major impetus to growth in the period before the current crisis. They see no reason to change this basic model for growth.

Weak political will also increases the Europeans' reluctance to take policy actions to improve their medium-term economic performance. Such actions are seen as entailing significant near-term costs. No serious consideration is being given to diversifying their economies by removing barriers in their economies created by rigidities in product and labor markets that constrain Europe's growth. Instead, the Europeans are content to wait for world growth to resume, with the mistaken impression that the world economy will essentially go back relatively quickly to levels of activity and demand similar to those that prevailed before the current crisis.

However, things will not be the same. In addition to slow demand growth in the United States, demand within Europe will grow significantly more slowly than previously. Growth in Eastern Europe will be less robust as these countries cope with the fallout from the current crisis. These countries will have to deal with an overhang of foreign currency-denominated debt. They are likely to encounter significant difficulties in rolling over existing loans and a drying up of new credit flows, particularly as western European lenders scale back their operations in the east. Moreover, these countries have generally experienced a significant loss in competitiveness. The only way for them to restore competitiveness, especially if they seek to maintain fixed exchange rates or limit exchange rate movements relative to the euro, is through slower growth in their domestic demand.

A bigger problem for Europe that will dim growth prospects will come from within the euro area. The area's southern countries (Portugal, Italy, Greece, and Spain) have become noncompetitive both within the euro area and externally. Since they are now members of the euro, they cannot rely—as they have in the past—on changes in their nominal exchange rates to produce real depreciations in order to restore their competitiveness. They have only two choices. They can raise competitiveness by improving the efficiency of their economies by undertaking needed structural reforms. Or economic growth in these countries will be constrained to significantly lower levels to allow for an improvement in competitiveness through lower inflation than in the rest of the euro area. The latter is the likely way that competitiveness will be improved. The political will to implement needed reforms

in these countries' product and labor markets is just not there. Consequently, the countries of southern Europe appear to be in for a long period of rather painful economic adjustment. And this painful adjustment process could severely test the future of European monetary union and the euro.

Slow growth in southern and eastern Europe will significantly impair growth in the northern European countries. This will be especially true for Germany, which has been very heavily dependent on exports to other European countries. Stagnation in Europe, coupled with slow U.S. growth, will directly depress growth in the rest of the world. But it may also have important indirect adverse effects on world growth. With slow growth throughout Europe and increased difficulties and stress in southern Europe, protectionist pressures are likely to rise. The recent EU decision to impose anti-dumping duties on steel pipe imports from China on the basis of prospective (not actual) injury to the domestic industry from such imports may be a harbinger of further recourse to import protection as recovery in Europe proceeds much more slowly than the Europeans currently expect.

Japan also cannot be expected to do much to pick up the slack in world demand. The country appears to be on the verge of slipping into its second major deflation in the past two decades, and it will remain dependent on exports for economic recovery and growth. At this juncture, the best the authorities are able to do is to try to limit the slide in the economy through some monetary and fiscal policy actions. Scope for fiscal action is limited because of the massive size of the government's debt and the need to ensure adequate resources are available over the medium term to meet obligations to Japan's rapidly aging population. Consumption growth is likely to remain constrained as household savings remain high, reflecting uncertainties about employment prospects and the government's ability to meet its pension and health care obligations without tax increases or spending cuts. Above all, Japan is mired in political instability that prevents it from taking meaningful steps to deal with structural problems in the economy.

The only hope for lifting Japan's potential growth rate and domestic demand over the medium term lies in implementing badly needed structural reforms—especially increasing the flexibility of product markets and improving access to the labor market. Enacting such measures entail taking on entrenched vested interests and changing cultural norms. The fact that they will not significantly alter near-term growth prospects makes them politically very unattractive and unlikely to be implemented in the current political environment.

Myriad rules, regulations, and restrictions severely limit the scope for new entrants, innovation, and increased efficiency in many markets in Japan, particularly in distribution and the services sector. Moreover, the rapid aging of Japan's population adds to the urgency to open up the labor market to avoid a further slowdown in Japan's already anemic potential rate of growth. Increased immigration may play a part in providing needed labor resources, but a far more important role could be played by bringing back into the labor force an already well-trained, but disenfranchised, group: Japanese women. The labor force participation rate of women in Japan is depressed by cultural factors, but more importantly it is constrained by the lack of adequate day care for children and elder care.

WHAT ABOUT ASIAN ECONOMIES?

Asia is considered to be the bright spot in the world economy at the moment. On the whole, the emerging market economies of the region have been judged to have weathered the economic and financial crisis better than the advanced countries and better than expected in late 2008 and early 2009.¹ Growth in many of these countries is seen as picking up after sharp slumps. This has prompt-

ed some renewed discussion about decoupling of Asian economies from advanced country growth and suggestions that major countries in the region—particularly China—could be engines of growth for the world economy. Unfortunately, this prospect is highly unlikely.² The perceived strength in economic activity in Asia at present looks to be associated with a temporary recovery in growth largely owing to a slowing of the rate of inventory decumulation or shifts to small inventory accumulation and to continued effects of fiscal and monetary stimulus measures. While Asia may be looking better than expected in 2009, economic prospects for the region in 2010 and beyond, in the absence of major changes in economic policies, will remain heavily dependent on recovery and growth in the advanced countries.

China, in particular, appears to be doing rather well, thanks to quick government policy actions to stimulate the economy. The authorities will achieve their 8 percent target for GDP growth in 2009. But relatively strong growth in China is not providing much stimulus for the rest of the world, as China's trade and current account surpluses remain large. Moreover, without a significant revival in external demand, it will be difficult for China to achieve its 8 percent GDP growth objective in 2010 and succeeding years, unless the government continues to supply substantial stimulus to the economy, especially given continuing policy biases that favor investment.

Since the mid-1980s, China's economic development has been driven by investment growth. In the early years of economic reform in China (which began in 1978), consumption rose strongly and was the major factor in China's growth. As economic reforms in the urban areas began in earnest in the mid-1980s, however, there was a distinct shift in growth back toward the kind of investment-driven model that dominated China's development in the pre-reform era. This shift accelerated after the Tiananmen Square protests in 1989. A basic flaw in this development model became evident in the early 1990s as rapid investment growth led to increases in the production of goods that outstripped domestic demand. Mountains of "unsellable" goods built up as the government sought to maintain relatively rapid growth.

To resolve the problem, the Chinese authorities decided to find new external sources of demand for Chinese goods. They chose to stick to the investment-driven growth model and rely on exports and substitution of domestic production for imported goods to fully utilize the excess in productive capacity over domestic consumption that continued rapid investment generated. Major reforms launched in 1994–95 opened up China's economy and served to shift production toward exports and import substitution.³ Also set in place were significant price distortions—namely a low cost of capital and an undervalued exchange rate—that supported this investment-driven/export-led growth model.

Policies that have maintained a low cost of capital in China have contributed to stunting the growth of consumption. Households over most of the past two decades have experienced a significant decline in personal income relative to GDP owing largely to a decline in investment income. Despite large savings, households' investment income has fallen relative to GDP because the major investment vehicle available for these savings are bank deposits and a low ceiling has been set by the government for the interest rates paid on these deposits. In turn, the low deposit rate permits the banks to lend to enterprises at relatively low interest rates. The cost of capital has also been held down by the virtual lack of dividend payments to the government by the state-owned enterprises.⁴ Consequently, retained earnings of these firms have been a large pool of low-cost financing for investment.

The low cost of capital coupled with the poor intermediation of savings by the major state-owned commercial banks has resulted in substantial resources being directed toward the large state-owned

enterprises, which tend to be in capital-intensive industries. As a result, production in China has become very capital intensive, creating the rather ironic situation that output growth does not generate much employment growth in a country that has such a large pool of underemployed workers. The official target for growth is set at 8 percent because that level of growth is viewed as being required to produce the 1–2 percent of employment growth needed per year to absorb new entrants to the work force and reduce somewhat the substantial underemployment of labor in the rural areas.⁵

At the same time, by maintaining an undervalued exchange rate, China has imposed growing costs on its economy. In particular, it has created a serious overallocation of resources in export- and import-substituting industries. This situation will have to be sorted out at some point, and the problem and the costs of sorting it out will only grow the longer adjustment is delayed. Moreover, when the inevitable appreciation in China's currency happens, the country will experience a substantial loss on the massive foreign exchange reserves it has accumulated while trying to keep its currency undervalued—a loss that the Chinese authorities are already very concerned about. Nevertheless, China's authorities are reluctant to allow the exchange rate to appreciate out of fear of the short-term impact appreciation could have on growth.

Maintaining an undervalued exchange rate also stunts the development of China's financial sector. Efforts to get its banking system to operate on a sound commercial basis are undermined by the government's continued interference in the banks' business decisions through heavy reliance on window guidance to control credit expansion and establish lending priorities. The government has been forced to rely on such direct measures to influence bank lending out of concern that use of conventional indirect means of monetary control, which would rely on increases in domestic interest rates, could induce increasing inflows of foreign money, especially since capital controls have become more porous.

China's growth model up to now certainly has delivered impressive results, making China the third largest economy in the world, and it is closing in fast on becoming the number-one trading nation. However, because of the country's success and its increased importance in the world economy, time appears to have run out on China's continued use of its investment-driven/export-led growth model. This is particularly true given prospects for slower demand growth in the advanced economies. Continued rapid investment in China will add to productive capacity and require continued strong export growth to make use of the excess in capacity over what is demanded domestically. But to maintain relatively rapid export growth in a slowly growing world economy, China's producers will have to lower their export prices to overcome competitive pressures, thereby cutting their margins substantially, in order to be able to take the ever-increasing share of world trade required for China to be able to maintain its 8 percent target for growth. However, with declining margins, Chinese firms would be expected to cut investment over time if they are operating on a commercial basis. In these circumstances, Chinese banks too, if they are operating on a commercial basis, should be increasingly reluctant to lend. Consequently, rapid growth and development in China cannot be sustained unless there continues to be strong fiscal support or increased government interference in business decisions. The situation facing China could be even worse if the country's attempts to maintain export growth were to invite increasing retaliation from partner countries.

In addition, the Chinese authorities are drawing the wrong lessons from the current crisis, leading the government to decide to play an even bigger role in the economy. Advanced countries' interventions in their financial systems are being taken as proof that China's system, which remains dominated by the government, is superior. The stability of China's banking system during the current finan-

cial crisis is only an indication of its detachment from world markets; it is not an indication of inherent strength or soundness. In reality, China's banking system is staggering forward toward its next crisis and recapitalization by the government. The system has been recapitalized twice in the past ten years, and only limited progress has been achieved in reforming it and getting it to operate like an efficient, commercially based system. The government's push to have the banks expand lending as part of its economic stimulus plan probably brings forward the date when another recapitalization will be needed, since substantial new nonperforming loans are expected to be created by the government-sanctioned surge in lending that has taken place. Advanced country interventions in the automobile industry are also seen as providing justification for China's efforts to restructure fourteen of its major industries. As part of these restructurings, China's large state-owned enterprises are envisaged as playing a dominant role in these industries. This is likely to be a major step backward for the economy.

The past success of the country's growth model makes the Chinese authorities very reluctant to do more than make gradual changes to it. Policies adopted by the authorities to deal with the current economic and financial crisis generally continue to focus on boosting investment and stabilizing export growth. Nevertheless, the Chinese authorities recognize the need for change. They have publicly stated that the economy needs to be rebalanced away from its heavy dependence on investment and exports toward consumption.⁶

Rebalancing China's economy requires removing price distortions and enactment of other policy changes to eliminate inefficiencies and incentives favoring investment over consumption. Serious distortions exist in the pricing of energy, other utilities, land, and pollution abatement; but, as noted above, the major price distortions are the low cost of capital and the undervalued exchange rate. Capital costs need to be raised significantly, and this cannot be done without permitting more flexibility and a more rapid rate of appreciation of the exchange rate.

The ceiling imposed on interest rates paid on savings deposits is a major factor behind the low cost of capital, keeping the bank lending rate low and holding down the opportunity cost for enterprises' use of their retained earnings for investment. This ceiling needs to be lifted. In turn, a higher cost of capital along with a stronger currency will help curb overinvestment in export- and import-substituting industries. Real household incomes would also be boosted by increases in both bank deposit rates and the exchange rate, and consumption would rise as a consequence.

Financial market reform is needed to improve the intermediation of savings in China. Lifting the cap on deposit rates would not only help push up the cost of capital, it would also increase competition in the banking sector and provide incentives for banks to expand credit to new customers. Bond and equity markets need to be more fully developed to provide alternative sources of financing for firms and a much broader array of assets for households to invest in. Small- and medium-sized firms have had to rely largely on retained earnings or the assets of their owners to finance investment. Consumers also have had limited access to credit. Better credit access and higher yielding assets to invest in would raise household incomes and reduce household savings over time, boosting consumption.

In addition, the government has an important direct role to play in rebalancing the economy. It has to continue improving critical social services, especially education, health care, and pensions. Reducing the uncertainties surrounding the provision of these services will substantially diminish households' strong precautionary savings motive and give households the confidence needed to raise consumption.

CONCLUSION

This paper paints a rather gloomy picture of the prospects for world economic recovery and growth. Given present tendencies in major economies, it is extremely difficult to come to another view.

The United States is the only one among the major economies that is experiencing adjustment in its savings and investment imbalance. Household savings have risen, and will rise further in the period ahead. Within the next two years, the Obama administration also will have to follow through on its commitment to consolidate the fiscal deficit, contributing to a significant rise in U.S. national savings. With this needed rise in savings, growth in the United States will be rather slow over the next several years.

But the slack in world demand left by slower U.S. growth is not likely to be picked up by any of the other major world economies. All of them have been, and appear likely to continue to be, heavily dependent on exports to drive growth. Europe is complacent and appears content to simply wait for growth in the rest of the world to lift it out of recession. However, in addition to the prospect of slow U.S. growth, Europe faces significant internal difficulties. Problems in eastern Europe and increasing difficulties in southern Europe will hold down demand growth within the region. In Japan, economic uncertainty and political instability are likely to continue to suppress domestic demand. In the rest of East Asia, emerging market economies will also continue to depend heavily on exports to generate growth. China, in particular, looks likely to continue to lean heavily on exports to try to sustain rapid economic growth.

Consequently, prospects for world growth look pretty gloomy, but they do not have to be. Each of the major economies knows what measures need to be taken to boost their long-term growth prospects (and with them, prospects for the world economy). There are no surprises here. The measures required have been discussed at length for many years. What continues to be lacking is the will on the part of the political authorities in most of these countries to act. The policy actions needed are in the best interests of each and every one of them. But it remains unclear as to what it will take to prompt the major countries to finally act.

Endnotes

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1. In large part, this better-than-expected performance reflects the overly pessimistic forecasts for these countries made in late 2008. China is a notable example. Most analysts forecasting China's growth for 2009 in late 2008 raced to mark down their forecast without giving adequate consideration to the effects of China's fiscal stimulus and credit loosening measures. As these same analysts now mark up their growth forecasts, there is a tendency to attribute the revisions to the Asian economies being more resilient to the crisis than to attribute them to forecast errors owing to underestimates of the effects of stimulus measures taken.
 2. This is a view shared by some leaders in the region. At the July 2009 U.S. and China Strategic and Economic Dialogue, China's central bank governor, Zhou Xiaochuan, suggested that a sustainable recovery in China's growth would not occur until the U.S. economy recovered.
 3. These reforms included unification of the exchange rate at a somewhat undervalued level; allowing 100 percent foreign-owned enterprises and providing tax and other incentives to encourage foreign direct investment; and comprehensive reform of the state-owned enterprises.
 4. Beginning in 2008, the central government's state-owned enterprises have been required on a trial basis to make modest dividend payments to the budget.
 5. In contrast, advanced countries generate 1–2 percent of employment growth per year from 2–3 percent of GDP growth. See Jahangir Aziz and Steven Dunaway, "China's Rebalancing Act," *Finance and Development*, September 2007.
 6. Chinese premier Wen Jiabao in his address to the National People's Congress in March 2007 said that "the biggest problem in China's economy is that growth is unstable, unbalanced, uncoordinated, and unsustainable."

About the Author

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