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LOOKING TOWARD THE FUTURE IN THE MIDST OF ECONOMIC UNCERTAINTY

By Martin Wolf

A *Financial Times* columnist looks at challenges facing the global economy and how the actions of governments could improve the situation — or worsen it.

HOW DAMAGING WILL THIS current recession be? When will the global economy begin to recover? The only honest thing one can say is that one doesn't know.

There are at least three very powerful reasons we don't know. First, we can't forecast economies. Forecasters always miss turning points. They can tell you what will happen only if things remain as they are. Turning points are inherently unpredictable. The consequences when things do change are always unpredictable for the same reason, because many other things are likely to change at the same time.

Second, the forces now at work are unbelievably rare, and we have never seen them before in this combination. That makes looking back on anything that's happened in history an almost useless activity. It gives you some guidance; there are better and worse guides. But there

is no clear guide that will give you more than a conceptual idea of what's going on.

The third reason we can't know how the global economy will perform is that future performance depends on what people—policy makers above all—actually do. There are choices to be made. So far, in the run up to and through this crisis, most of the choices made have turned out to be bad choices. We've ended up with the worst of all possible worlds at the moment. If people go on making bad choices, the result will be a depression lasting many years. If they make what I think are the right choices, we may still end up with a severe recession but avoid a severe depression. Those are, I think, the most important things to understand. Anyone who claims to know what's going to happen is lying.

The Forces at Work in the Current Predicament

The forces at work in the current climate are at least moderately clear; we've got three gigantic things happening at the same time that are forcing the world economy in this negative direction. First, for a very long period, household consumption in the United States and a number of other smaller developed counties (particularly the United Kingdom, Australia, and Spain) played a very large role in supporting demand around the world because these households were consistently spending much more than their incomes and borrowing to make up the difference in an era of easy credit.

This spending-beyond-one's-means was supported by a series of asset-price bubbles; far and away the most important in this regard was the house-price bubble, which has now ended in these countries, starting in the United States in 2006. Because households have been losing wealth, and because of the collapse in equity markets, people are cutting back on their spending very quickly. If they continue to do that, that guarantees an enormous recession.

To give you a relevant example, the average U.S. consumer has been spending all of his or her income and borrowing a lot more besides, and savings rates have hit zero. Consumption has been greater than household income and has been the principal source of demand in the U.S. economy. If households go back to saving at a more normal rate, which will be somewhere in the neighborhood of 6% to 8% of disposable income, that alone, if it happens quickly, will reduce GDP on the demand side by about 5%. That will feel like a depression. It will certainly be worse than any recession since World War II. The first thing that is happening is immense pressure on the high-spending households.

The second thing happening is a reversal of the expansion of the credit system and the financial sector in the world, particularly in the developed countries. Over the last 25 years or so, the balance sheet of the financial sector of the United States has grown about six times faster than GDP, generating an extraordinary increase in income for the people in the financial sector. This has led to a massive increase in leverage and low capital ratios. This expansion of the balance sheet of the financial sector financed enormous indebtedness in households in the United States and United Kingdom. Household indebtedness has doubled in relation to disposable income over the last decade.

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As a result of the decline in asset prices and the losses associated with that and the very small equity base of much of the sector, the financial sector is effectively decapitalized —i.e., bankrupt. If it were properly, rigorously, evaluated, a large part of it would look bankrupt, and government would have to recapitalize it. Today's financial sector wants to lend less, reduce its balance sheet, and get people to pay back the money it lent, and that leads to the third problem: Credit is much more difficult to obtain than it used to be as a result of what happened in the financial system. This, then, is "deleveraging."

You add these three things together and you have an enormous contractionary force operating in the countries that generated very large and buoyant demand growth over the course of the last decade. You have to ask yourself, if they save more and spend less, what is going to offset the contraction? What might offset it to get us out?

When you think about that, you realize it can't be investment. Companies invest less in recession. Companies will follow households. That leads you with two sources of demand: One is government, which will spend much more. That spending might be financed by the printing press, or even by the central bank. That is part of the short-term solution, in my view. Governments are creditworthy; everybody wants to lend to them. Government spending is a temporary solution. It's a good one. It will help households to go through a period when they're saving more and improving their balance sheets.

The other thing that will help these countries is export growth. Most U.S. growth in the last year or so has been generated by exports. That leads to the final big problem: For exports to grow from economies that are so big, you need very strong and vigorous demand from countries that are not heavily burdened by debt. Unfortunately, most of these countries have shown no willingness to increase their spending at rapid rates, with the marginal exception of China.

For all these reasons, we can expect a deep and self-fulfilling recession—prevented from becoming a depression by enormous increases in fiscal deficits to levels of perhaps

10% of GDP or more. This will be financed perhaps by borrowing from the central bank. It's going to take a long time before demand grows in the private sector of these debt-afflicted economies, and I don't see anything very strong coming from the rest of the world.

There are two other elements to what is going on, one of which is promising, the other interesting. The promising one is that we no longer have much, if any, inflation concern. Commodity prices have collapsed. That's shifting income back to households, making it easier to save and spend more without cutting back on their consumption, because their real incomes are higher. It's also removing income from the high-saving countries, which is helpful. Lower inflation is allowing central banks to be aggressive in their interest-rate policy, which should help households. That is really quite a positive element.

The second element is what's happening in the stock markets. We've been in a structural bear market at least since 2000. We had an enormous overvaluation, particularly in the developed world, in 2000. The aggressive monetary policy used to offset the impact of the stock market collapse on the economy in 2001 and 2002 had the consequences we now see in terms of the balance sheet of the financial sector.

The collapse of the financial sector is now leading to a further collapse in the value of stocks. But I do believe that stock markets are beginning to look fairly valued or even cheap, given the proper understanding of the risks. That fact may in time induce people to start buying stocks, once the economy improves.

Getting out of this will require aggressive action by governments to prevent total collapse in demand and a total collapse in the financial system. They've taken dramatic actions on the latter, but they have not done enough on the former to get demand growing again. To get much bigger fiscal boosts, in my view, we need much more aggressive action to make sure newly recapitalized institutions at least provide financing to business.

If those things all go well, I think we can avoid a depression, have just a very deep recession, and see weak recovery of some kind in 2010 or 2011. But this is bound to be the deepest global recession since World War II, and the first one on which all the developed countries are in recession. It's going to be a very slow process.

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Government Measures: The Effect on Demand

Once you get into a situation like the one at present, where interest rates are so low, you can't separate monetary and fiscal policy. Monetary policy cannot support the economy by lowering interest rates anymore, because rates are already so low. But stimulation can be done either by directly lending to the business sector, which increasingly the Federal Reserve is doing, or by lending to the government to spend.

The government can avoid accumulating large debt by the simple expedient of borrowing short term from the banking system or from the Federal Reserve. In the present situation of extreme liquidity preference, where everyone wants to hold cash, there is no inflation risk associated with that whatsoever. In the long run, that may be different. It's perfectly reasonable for the government to borrow short term and give the money to people and things where they know it will be spent. They can spend on investment and projects that can be done quickly. That would be a good thing to do. They can finance the poor, who always spend money; employment compensation will be spent. There are plenty of things you can give money to people for that will result in spending.

Generalized income tax cuts, where most tax is paid by the well off, won't be a useful way to stimulate the economy. But it would at least give strength to the balance sheet of the household sector. The government should do all of these things on an exceptionally large scale.

It's important to remember that we got out of the Great Depression essentially by a huge public-works project called the Second World War. I'm not recommending war, but it's a reminder of what can be done. There are some risks with such projects. If a country with a large current account deficit prints money like this, maybe the currency will be dumped. It would be better, therefore, if everyone does it at once. But in a deflationary situation like this, I think the United States, perhaps a bit less the United Kingdom, can get away with substantial increases in domestic money, because I don't think other countries would dump U.S. currency; it would destroy their own competitiveness. If it forced them to destroy the value of their own stocks of foreign currency reserves, it would not be a very good thing.

There are many ways to provide money to get it spent. Once we get the household sector back in shape and the stock market at a reasonable price, and people again start buying stocks and finance companies through the stock market or through debt, then you will want to see the government deficit start to diminish. That's why I think the best forms of stimulating the economy have to be things the government wouldn't ever do forever.

For instance, unemployment compensation helped the economy during the Great Depression. Similarly, funding large-scale investment programs that, once they're finished, they're finished, should help now. If you're talking about large, permanent spending increases, say a uni-

versal health-care system, those must be funded by permanent increases in taxation or reduction in spending—not part of this package. In the long run, when everything gets back to being healthy, you would expect deficits to shrink. You would expect the private sector to spend more and revenue to improve. The government's need to spend diminishes. It will all go away again.

In the end, it would be sensible for the United States to move back into surplus: withdraw the money that has been printed or start selling bonds to mop up the money. Clearly, at the very end of the process, government debt will be higher than it is now, but household indebtedness will be smaller, with luck.

It's important to understand that this clear borderline between private and government indebtedness doesn't work at the macroeconomic level. There's a relationship between the two. When households have large amounts of debt they can't pay, they stop spending. It is the government that comes in by printing its own debt, which everyone will then want, and that's what's happening now. So I think the process will be reversible later on. It has always been possible to reduce deficits and debt, provided the policy is reasonably disciplined. Right now, it's a question of spending and financing by borrowing from the system in the short term, not worrying about bond finance, and just making sure we get through the next two or three years without a total self-fulfilling and reinforcing collapse in the economy.

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In my book *Fixing Global Finance*, I argue that the United States is as much a victim of others' decisions as it is the cause of its own misfortune. Over the course of the past decade, the world's developing nations fell into this strange habit of giving surplus money to the United States in the form of loans. Really, they should be spending it domestically, and developed nations should be spending more in developing nations. This is a much healthier flow of capital.

On this point, many serious professional economists—there are exceptions—would agree with me, yet this is seen as a controversial view. The United States is embedded in the global economy. It's the biggest economy, but it's still smaller than the rest of the world. It's roughly one-fourth of the global economy and the rest is three-fourths. What the rest of the world does has an enormous effect on the United States. It's not just one-way. It so happens that, for reasons I lay out at length in my book, the rest of the world undertook a series of actions. In response to a financial crisis of an earlier decade, they kept the exchange rate down and started to generate large export surpluses and so to export capital. This was particularly true of China but not only of China. That, in my view, created strong deflationary and recessionary pressure in the United States.

Import surpluses are withdrawal from a country—domestic demand going abroad. The U.S. Federal Reserve, not totally consciously, chose to offset this deflationary pressure in the early 2000s by greatly expanding domestic demand; it was purely accidental. The same thing followed from the Bush tax cuts in the early part of his administration. The United States was responding to these external pressures. I don't think it responded intelligently, unfortunately. In this response, the United States allowed this later financial mismanagement. And so, in the end, a large part of the domestic U.S. counterpart of this lending turned out to be borrowing by fundamentally insolvent households with assets that were fundamentally overpriced, intermediated by a financial system that turned out to be undercapitalized.

If you think of that combination, it was the worst way to try to stimulate the economy. It would have been better for the United States to run bigger fiscal deficits in this period and invest the proceeds in bridges and roads and railroads and whatever capital investment made sense. The investment it did undertake was to build houses that nobody needs. It's a sad story. The big macro-picture is, however, an important indication of the way the United States is not master of its own fate.

This gets to the second big point. If we are going to get out of this cleanly, the U.S. economy needs to rebalance. We don't have to go back to a big borrowing binge. We can't run fiscal deficits of 8%–10% of GDP forever. That's clearly unsustainable and will sooner or later destroy the credit and the currency. So the United States has to save more at home, and it has to have a balance in the current account and reduce its debt that way. But the United States and the other countries can only do that without having a huge depression if other countries in the world voluntarily expand demand in relation to their potential supply and move into current account deficits themselves.

The big question now is whether other countries with large surpluses understand that they are going to have to adjust to and expand demand. The issue is not simply one of expanding U.S. fiscal deficits; it's also one of seeing that the longer-term adjustments in the world economy are going to have happen. Seeing those adjustments will take American intellectual and political leadership. ❑

About the Author

Martin Wolf is chief economics commentator of the *Financial Times* and author of *Fixing Global Finance* (Johns Hopkins University Press, 2008).