Adjusting Growth Targets and Policies to the Post-Crisis Reality

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Key points:

- ***The uneven recovery with advanced economies heavily constrained:*** *the aftermath of the crisis, including the cost for tax payers will damage advanced economies. But the developing world "decouples".*
- ***Optimistic consensus forecasts:*** *in spite of the constraints, forecasts point to world growth returning to its pre-crisis trend of 4-5%, helped by surging growth in emerging markets - but there are threats to this relatively positive assessment.*
- ***Uncertainty over long-term projections:*** *forecasts must reflect the uncertain scope for long-run growth in the advanced economies.*
- ***Doubts over development:*** *there are also risks to progress across the developing world – is the outlook as strong and secure as forecasts suggest?*
- ***Growth models for the post-crisis era:*** *targets and policy settings need to be carefully considered in light of the lessons learnt and the high cost of the crisis.*

1. Introduction

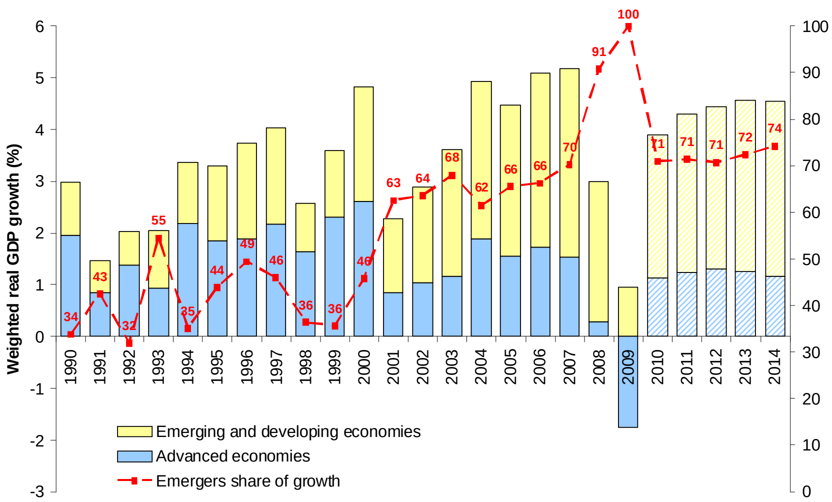
The global crisis has amply demonstrated that advanced economies are not immune to debt crises and severe financial instability, for which they are now facing a heavy price. But the recession has also raised wider questions over the desirability and viability of existing models of economic growth and, indeed, about the scope for future growth. This crisis, even more than previous recessions, has served to cast doubt on many commonly held assumptions over how countries can best achieve and sustain development in the future. It is possible to go so far as to say that some assumptions were plainly wrong. For example, the business cycle was not tamed, indeed this recession has been on a once-in-a-century scale, and trade was not resilient to systemic shocks but created a tsunami effect around the world. The growth models and policies adopted around the world, and the risk assumptions made by financial markets, reflected far more favourable assumptions than were warranted, with unfortunate and devastating consequences.

The shocking post-Lehman collapse in world demand and trade affected even countries which were not involved in the financial storm. The almost instantaneous collapse in world investment and trade meant that the hardest hit economies were those either heavily dependent on capital inflows (such as Emerging Europe) or dependent on trade (notably Singapore and Hong Kong but also much of Asia) and on cyclical exports (such as Germany and Japan). Housing bubbles were already in the process of bursting from before 2008, causing specific problems in some countries (eg in the US but also Spain, Ireland, parts of Eastern Europe and Dubai) but the main channel of contagion from this has been the international securitisation of related debt, with the collapse of the US mortgage market acting as the trigger for the global financial crisis.

Another notable lesson from the crisis is how to build resistance to shocks: the countries that were most resistant were those with large, stable service sectors and robust domestic conditions (eg France, which also has one of the largest state sectors) or with ample scope for supportive policy action (primarily China and Australia).

By now the world is getting back to a semblance of "business as usual" although the performance across countries remains uneven, with the advanced economies struggling to return to robust growth. In contrast, the dynamism is coming almost entirely from the developing world, led by China. "Decoupling" is back and is expected to continue, delivering world growth at around peak rates of 4-5% per annum (in PPP terms) according to optimistic consensus forecasts. Is this outlook secure? The risks seem to be all on the downside. In addition, have the lessons of the boom-bust been thoroughly digested? It is highly instructive to examine the varying outcomes for leading economies for what they may suggest in terms of possible growth models for the future. Has there been sufficient and deeper thinking about the appropriate choice of strategies for the post-crisis world?

Figure 1: World growth continues to be dominated by the developing world



Source: IMF

Many governments must urgently address issues such as fiscal constraints and debt reduction but they also need to look ahead to a broader agenda, reflecting on what they want to achieve for their economies and how this may be accomplished, carefully considering their policy options for guiding economic growth. Do they want to target high growth strategies with potential exposure to turbulent cycles - or focus on reducing risk and vulnerability to shocks even if this implies a slower (but more stable) growth path? Steady, sustainable growth will require a judicious balance between savings and debt, domestic and external demand, the public versus private sector while large imbalances in trade may need to be actively curbed for surplus as well as deficit countries. And more attention must be paid to the sectoral composition of the economy as excessive dependence on highly cyclical segments of manufacturing may pose a high risk in the event of sharp global downturns. Fostering growth in more stable sectors and local services may be advantageous, especially for jobs, and could be even more attractive than it appeared during the pre-crisis years.

In addition, doubts over long-term growth prospects have escalated, in part due to the prolonged impacts of the crisis, which will hold back the next generation of investment in the advanced countries. The major industrialized economies are already at the frontier of technology and productivity while facing negative demographics – achieving a return to previous trend growth rates would already be difficult to sustain even without the constraints of the post-crisis financial squeeze and government cut backs. Although, in principle, developing countries still have plenty of scope for catch-up growth, this too may fail if global demand weakens and the costs of development soar, putting the cost of the necessary infrastructure requirements out of reach.

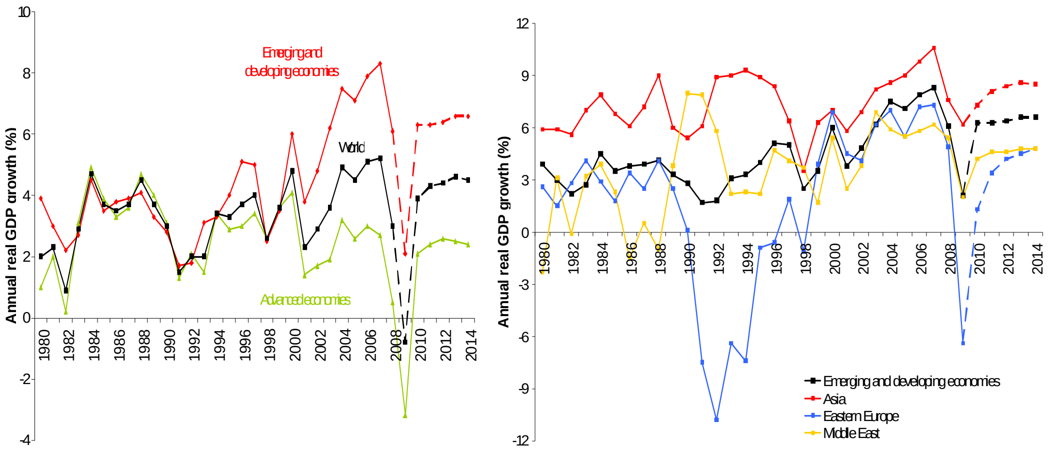
In contrast to relatively optimistic consensus forecasts for a robust post-crisis recovery and rapid return to previous trend growth rates for the world economy, the alternative scenario is more pessimistic for a variety of reasons. There may be a short-term surge in activity as recovery moves ahead and the developing world does have potential to achieve high rates of growth over the long run – the key issue is whether such growth trends are sustainable or will lead to more instability. What targets and policies may be most appropriate to enable countries to sustain healthier, less risk prone growth in the future?

2. The uneven global recovery

- *Governments curbed the global recession in 2009, but at a price*
- *The advanced economies are recovering but will see a period of low growth as they pay off the costs of bail outs and heavy fiscal support*
- *The developed world will also struggle to replace jobs lost and find new drivers of growth, which will have to come from the private sector given the stark constraints facing public sector finances*
- *But decoupling continues as growth in the emerging markets remains well ahead of the advanced economies, led by Asia and primarily China*

The only positive contribution to the world economy over the crisis period has come from the developing world – chiefly China and India. In general, developing countries have recovered their losses very quickly, particularly Asia which has had the benefit of China's strong performance to boost regional trade. Although there were some, mostly temporary, dislocation effects because of disruption in capital flows and global finance, the downturn in developing economies was chiefly caused by the collapse in manufacturing trade and commodity price volatility. Although commodity prices rebounded quite quickly last year, trade volumes still remain weaker than pre-crisis and exports to the advanced economies are only recovering very slowly. Nevertheless, fairly steady domestic demand in the developing countries themselves and the boost from both rebounding commodity prices and growing sales to robust economies such as China, has allowed growth rates to pick up fairly rapidly in most regions. The main concern is Eastern and Emerging Europe (including Eurozone members such as Greece) given the region's overhang of debt problems and steep economic decline in 2009 – the recession there could drag on. The lessons, primarily to avoid excessive external indebtedness, are clear - and were well known even before this crisis.

Figure 2: The "consensus" view



Source: IMF

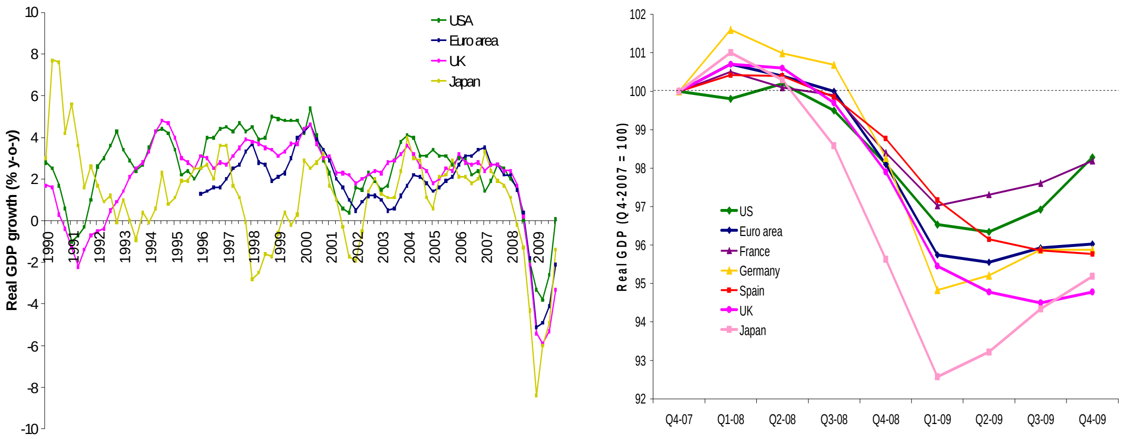
However, for the advanced economies, the recovery is uneven and certainly less buoyant. At best, the more flexible economies such as the US are rebounding and may return to their pre-crisis trend growth rates. But in Europe, there is serious concern that the crisis will lead to a prolonged period of little or no growth followed by a permanent downgrading of long-run potential growth due to weak productivity increases, which would come on top of a growth outlook already dragged down by negative demographics. The issue of long-term growth will be discussed further in Section 3.

Certainly, over the short to medium term, the advanced economies face significant constraints to growth, with public sector cut backs leaving growth highly dependent on a weakened private sector. This implies that a full return to 'business as usual' is unrealistic.

Even if there is a modest post-crisis surge due to pent up demand, private sector demand and business investment are likely to be less buoyant than they would typically be during a recovery phase given the need to reduce indebtedness and reconstruct balance sheets. Whatever recovery has emerged has been propped up by stimulus packages and there is a risk that demand could relapse as government support starts to be pulled out through 2010-11. High public sector borrowing requirements will nevertheless persist over the next few years and might crowd out private sector needs, dampening investment prospects even more.

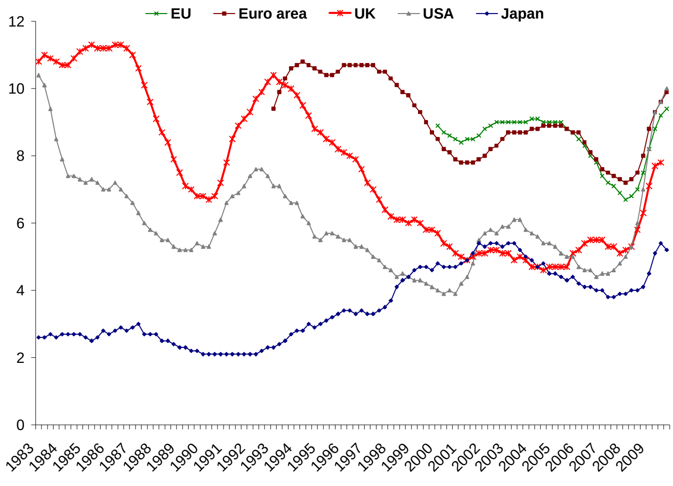
On top of a restrained picture for private sector growth, financial constraints are placing a heavy burden on governments. Sharp fiscal retrenchment is inevitable. While alleviating crowding out, public sector cuts will curb short-term growth, possibly putting jobs at risk.

Figure 3: A weak recovery in the advanced economies



Source: IMF

Figure 4: Unemployment rose steeply but may be flattening off (% labour force)



Source: Eurostat

In addition to the poor prospects for domestic demand expansion, trade growth also looks set to be less dynamic than it was – a particular hazard for countries, such as Germany, that have depended on export growth to drive their economies. In the short run, this will be due chiefly to weak import demand in the advanced economies and Emerging Europe (the region worst affected by the crisis and a particularly important market for German exporters). Over the longer term, there may be an additional brake if countries move to adopt more domestically-focused policies, promoting non-tradable sectors and local jobs.

Economic integration will remain a powerful force in the world economy but industrial restructuring could become more interventionist in some countries, partly in support of local companies and jobs but perhaps also with the aim of reducing exposure to the type of global trade risks highlighted by the recession experience of 2008-09. While world trade has tended to accelerate at a much faster rate than GDP over many years – typically increasing the shares of both exports and imports in GDP – this process may be far less pronounced in the post-crisis era, impacting on export growth prospects for the world's largest exporters, including China as well as Germany, Japan and also the US.

Concerns over resource costs and constraints will also figure more prominently: economies will have to adjust to permanently higher and more volatile commodity prices and the prospective scramble for access to resources. Offsetting the risks of resource scarcity and climate change will require considerable new investment spending, which will be even more difficult to achieve under tight credit conditions and public sector cuts.

While the advanced economies look hemmed in by constraints, consensus forecasts point to the scope for developing economies to continue growing rapidly, remaining the main contributors to global growth. This expectation is largely based on the potential for further rapid catch-up in productivity, increasing urbanization, rising living standards and fast developing consumption. Although the advanced economies will remain the largest market for goods and services in the near future, their relative importance will gradually decline. The developing world will become the dominant force in consumer markets as it already is in setting the pattern of world growth.

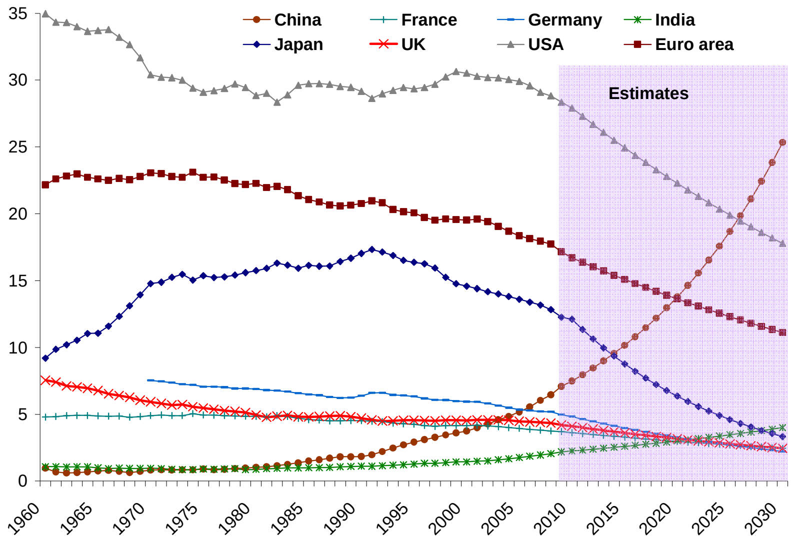
However, it is important to caution that such consensus forecasts may be misleading for both the developed and the developing world. The risks for the former are perhaps more obvious than for the latter but nevertheless it is possible that potential for catch-up growth might not be realised, for a number of reasons. The developing world is also very dependent on China, both directly in terms of market impacts but, even more importantly, indirectly in terms of its role as a "growth model". This might be dangerous should China fail.

To summarise the risks:

- *Europe suffered the deepest recession and the recovery remains weaker than in the US: there has been almost no recovery in domestic demand and the Greek debt crisis has highlighted wider financial risks and problems with monitoring and policy across the EU*
- *European growth could therefore remain close to zero over the next decade, mirroring the performance of Japan during its "lost decade"*
- *Japan will also remain too weak to provide much stimulus to other countries in spite of improved export prospects within Asia*
- *In addition, the US is not immune to risks: it still faces difficulties in property and banking as well as being highly dependent on its easy policy stance, which will have to be reversed*
- *And the developing world could see growth decline*
- *China has been the main stimulus to world growth but it is developing signs of overheating including a frothy property market - so Chinese growth will probably slowdown in the second half of 2010 due to these emerging pressures and an expected tightening of policy, especially the reining in of bank credit*

- *Other developing countries cannot replace China: they are simply not a strong enough force in the world economy and, in addition, many are to some degree dependent on China*
- *It is easy to forget that even by 2020-2030 India will only just be reaching the size of today's China and other economies remain even further behind*
- *In summary, there more downside than upside risks to the growth outlook and the consensus view may be overly optimistic*

Figure 5: Shares of world GDP (%) based on constant prices and market exchange rates



Source: World Bank and own extrapolations

3. Long-term growth becoming more difficult to achieve?

Achieving long-term growth in the advanced economies is becoming ever more difficult as they operate at the frontier of technology and productivity – making it harder to find new ways of raising output/employee. In addition, their demographic outlook is also less favourable than it was, with prospects of tightening labour markets as the working age population may not just stagnate but shrink.

These two factors, population trends and productivity, crudely determine economic potential (output/capita grossed up for the number employed) and it is not clear where new impetus can come from if these fail. Of the two, productivity is the hardest to estimate, subject to many uncertain influences, while demographics are relatively certain. Yet even demographic forecasts are subject to margins of error – for example, migration changes could feasibly create significant shifts in population data, especially for the working age group. However, by and large, population projections are accepted as a benchmark on which to base economic forecasts.

In the developed world, the population of working age, the potential labour force, will probably start to shrink over the next decade due to demographic pressure (especially in Europe, but later too in the US). Nevertheless, even ignoring scope for migration, the numbers employed need not shrink quite as much as the working age population for a number of reasons: participation can increase (it remains quite low in some countries), unemployment can fall (eg in countries with still high rates) and older workers may continue for longer in employment. These factors can all squeeze more GDP out of the economy. This is even quite an attractive scenario as social costs would be cut by falling unemployment and older people working and there could be more focus on better quality jobs rather than low grade activity, potentially raising average productivity in the economy. High productivity sectors could be further encouraged by new technologies, innovation and organizational improvements and also by attracting high-skilled talent (both local and global). In contrast, low productivity sectors and companies could be shed as the labour market tightened and unemployment fell (even allowing for the fact that there must be jobs for different skills and levels in any country in order to avoid social exclusion).

Why then is this demographic change seen as such a negative force? Instead of the prospective scarcity of workers logically promoting a move to higher skill levels and productivity growth, many fear the opposite is happening with skills falling behind. If true, this could be very dangerous but such a trend clearly is not related to the “ageing” issue – this does not imply that young students and workers should become less productive! Yet, somehow, “ageing” seems to have become equated with decay and decline, encouraging economic pessimism, while population growth and “young” populations are promoted as being more dynamic. This is strange as there is little evidence to support such a thesis. In fact, however distasteful it may be, the fact is that under a low population growth strategy, China has succeeded in rapidly upgrading productivity and living standards whereas countries with very high indigenous population growth have typically found it far harder to achieve rapid gains in education, skills and productivity. Large, growing populations do not guarantee a successful economy – and there is no clear reason why a smaller population should be locked into low productivity rather than achieving higher productivity growth, especially in advanced economies.

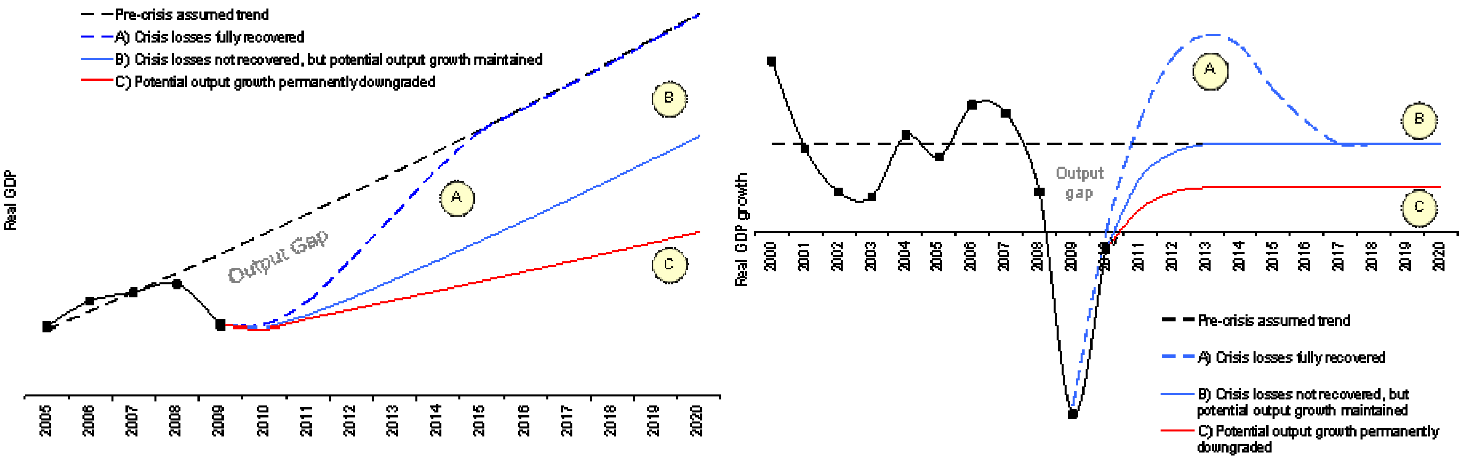
Looking now at the impact the crisis has had on long term growth projections, we may ask why these should change at all – economies could make a full recovery, as Asia did after the crisis of the late 1990s. A full recovery would be equivalent to scenario A in the charts below – and developing countries generally seem to be following this path.

However, for the US and Europe, the A scenario may not be achieved. The demographics are the same post-crisis and pre-crisis, and the recession could be viewed as just a temporary disruption in the long-run equilibrium path of the economy, but there are valid concerns about the recovery in productivity growth. The loss in jobs and investment could have more persistent consequences for productivity gains over the next decade – and de-motivate young workers from training and acquiring skills, for example. Some of these effects could be reduced through policy action but others may linger.

Nevertheless, it is difficult to justify more than a small adjustment to long-run productivity based on the impacts of the recession alone – there could be some permanent loss in GDP but growth could return to trend – the B scenario. This is generally the expectation in the US. But in Europe, forecast downgrades seem to be pointing to a more permanent reduction in trend growth – that is, scenario C. Most likely, these forecast adjustments also incorporate other explanations that may well have been overlooked or under estimated pre-crisis – but the implications of this change in view are quite harsh, including the impact this will have on targets to reduce public sector debt.

Such a shift hardly offers an inspiring vision for the economy of the future. Is this partly motivated by a policy shift to reduce economic risk and seek structural changes in the European economy that will make future growth lower but more stable and secure? The issue of growth model selection is examined in the last Section.

Figure 6: Recovery scenarios A, B or C?



Alternative scenario: risks around the world

Before passing on to the issue of growth models and the choices of the advanced countries for their economic future, it is important to recognise that there might be impacts on the rest of the world from this – and there are risks in the rest of the world – that should also be taken into account:

- *The cost of the recession, bouts of turbulence and failure to develop a new growth strategy and skills could imply virtually no growth in the advanced economies over the next 10-20 years*
- *Failure to improve technologies and weak investment in resources and other key sectors such as power and infrastructure will reduce the world's opportunities to deal with issues such as resource constraints, climate change and the challenge of alleviating poverty*
- *Will the world be able to afford further development? For example, infrastructure is typically resource and energy intensive, which will be ever more costly*
- *Much of the developing world may struggle to grow and there will be many more failing states – in contrast. the most successful regions will be those that can afford to plan and build for a more secure future today*

The developed world, if it invests at all, will focus increasingly on efficiency gains, safeguarding strategic supplies, reducing risky import dependency and improving self-sufficiency in energy and other resources. This would be in-line with a "secure and stable" growth strategy. Even before the recession, the developing world, led by China, was the driver of both global investment and demand for raw materials, for example, accounting for 75-100% of the increase in global consumption of energy and metals over the last decade. India is trying to emulate China - will it succeed and is this a race against time? If India follows China's development path, this will have immense impacts on raw material demand and prices. On the other hand, India still lacks China's financial resources and drive and development may stall due to the escalating costs involved. Access to finance, the problem of rising costs and lack of cohesion might constrain other emerging market economies as well – might this imply that China could be the last big development project? This is an important alternative scenario to consider not just for the developing world but for the advanced economies as well.

4. Alternative growth policies for the future?

Growth policies for advanced economies must also be carefully reviewed in light of the crisis: there is clearly a choice between prioritising high growth strategies that increase the risk of turbulent cycles (whether through a build up of financial stress or through excessive exposure to volatile export growth) and the adoption of slower but more stable growth strategies that seek to reduce risk and vulnerability to shocks. Regional and global considerations must also be taken into account given that imbalances tend to magnify and 'globalize' stresses and strains in domestic markets (ex: sub prime debt, the PIIGS in Europe).

Overall, in light of the lessons learnt, future growth models might focus more on:

- *Achieving a safe balance between domestic and external demand driven growth*
- *Addressing any unsustainable build up of debt, excessive imbalances in trade and finance or risks to the balance of payments*

And the choice of 'stability' rather than 'volatility' will also require:

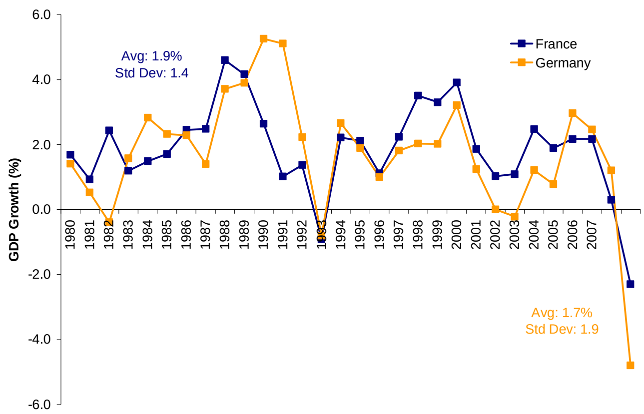
- *Reduction of excessive sectoral dependence, particularly on cyclical sectors*
- *Promotion of non-cyclical sectors and jobs to reduce risks and take the strain off public sector led bail outs of the economy in a downturn*
- *Identification of asset bubbles at an early stage and efforts to detect and correct the dangerous origins of such bubbles (eg excessively lax credit and mortgage*

conditions, low interest rates) – the key here is to treat the root cause of the problem, not the symptoms.

Perhaps one of the best illustrations of the implications of choosing a particular growth model can be seen in the comparison of France and Germany. The differential performance was clear for many years before the crisis: historic growth trends show the greater volatility in Germany compared with France, with Germany doing poorly in past recessions such as 1982 and 2002-03. Including the 2009 result, there is not even a trade off between growth and volatility – France has achieved both higher growth and lower volatility than Germany in terms of GDP performance, albeit the differences are not very large, with the 2009 gap the most significant point of departure.

These countries both have the same currency and monetary policy, they share similar living standards, productivity levels, policies and goals – yet there have significant structural differences, chiefly in their relative weight of services, public sector employment and manufacturing exports, which cause varying reactions to external shocks. There is a substantial contrast between the big impact of the global slump on the export oriented German economy and the shallow recession seen in France.

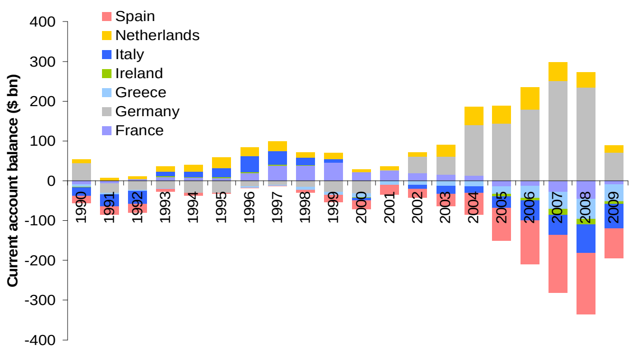
Figure 7: GDP growth, France and Germany



Source: IMF

Automatic stabilisers (partly government subsidies paid to companies to retain workers) did prevent Germany's unemployment from rising steeply (stabilising local consumption) but GDP fell sharply as exports slumped. In contrast, France's robust service sector and a very large state sector (the largest of the major advanced economies) created a stable buffer in the face of the global shock, thus GDP saw a relatively small drop and fairly quickly picked up to just 2-3% below its previous peak by the end of 2009.

Figure 8: Current account imbalances across the EU



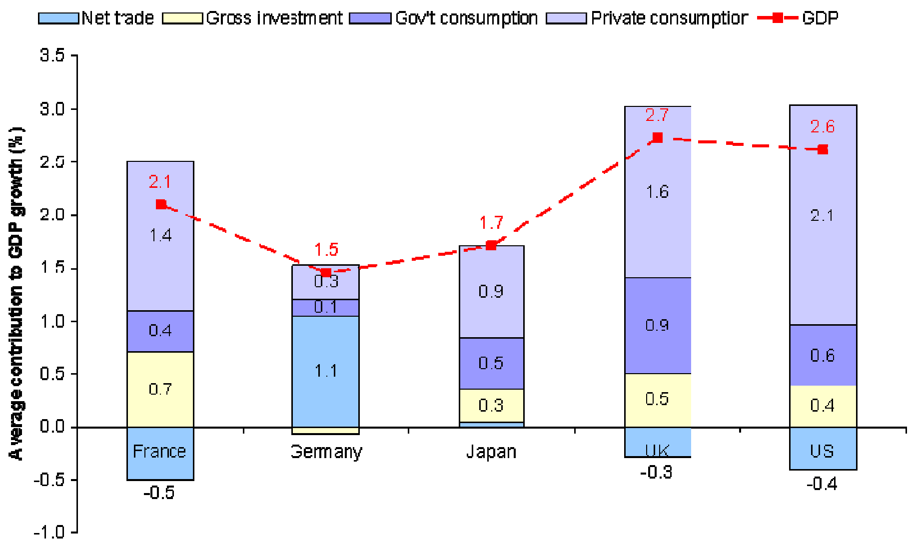
Sources: Eurostat, OECD, based on nominal GDP accounts for Germany

Germany's export driven growth model has come under fire for various reasons – including its impact on Europe's internal imbalances. The suppression of wage growth may have kept exports very competitive but at the cost of a heavily distorted economy and impacts on other European markets. However, the recession may lead to re-examination of priorities as the costs of supporting manufacturing industry through a slump may become a matter of concern, especially if global cycles are repeated and if export markets in Eastern Europe – the key new area for sales over the last decade – do not rebound.

The case of France illustrates an alternative method of damping global shocks, although this too added to the costs of the public sector. The support provided by the US service sector also prevented the US economy from suffering an even steeper recession – given that it was at the epicentre of the financial crisis and property slump, this was not mean feat even taking into account the massive fiscal stimulus provided.

In general, insulating large economies from global shocks by maintaining a strong domestic market and stable sectors for jobs seems a natural defence mechanism – in contrast basing an economy on very large manufacturing operations to serve global markets that are far bigger than the home market is fraught with risk in the case of any significant change in global market conditions. Industry concentration and specialisation may be logical to achieve the greatest economies of scale – but it is not a robust solution in the face of unexpected and uncontrollable shocks. Efficiency must be traded off against security – the principle of portfolio diversification can be applied as much to the benefits of maintaining a spread of industrial activities as it is to financial fund management. It may not be appropriate to press this argument too far but diversification to limit over exposure to risky activities by growing more stable sectors seems a reasonable policy recommendation which should be examined while the costs of the crisis are still visible – and before another crisis comes along.

Figure 9: Contributions to GDP



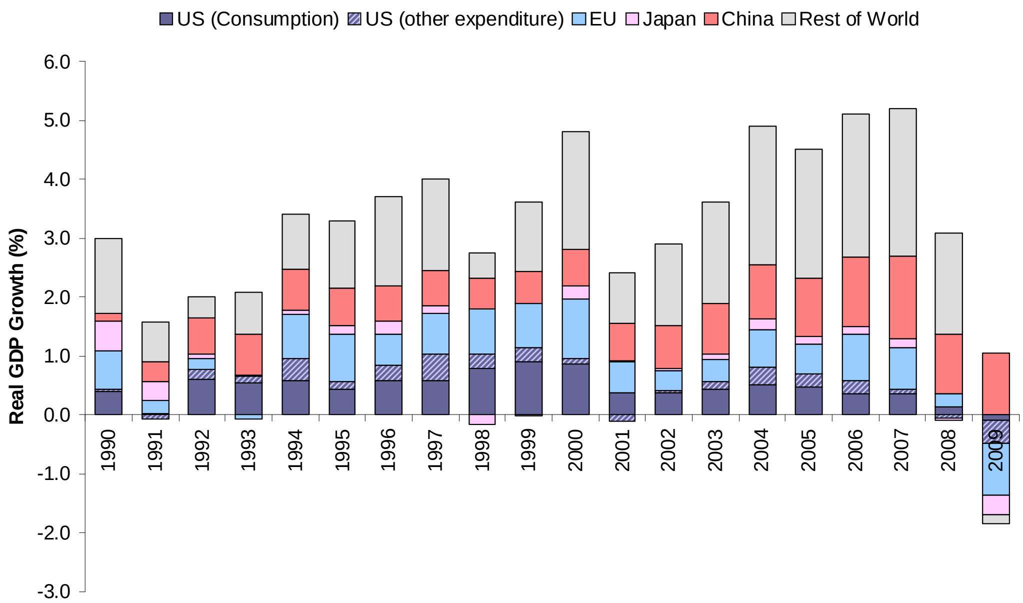
Source: OECD (based on data for 2000-2007)

While the export risk has been highlighted most, this is not quite fair. There are also risks in pursuing too aggressive a strategy of growth through local consumption – as in the case of the US and UK. Raising debt and escalating spending in conjunction with a property boom creates imbalances and the risk of a turbulent end to the cycle – as the crisis has shown. But this risk was flagged long before the crisis whereas the role of the export risk was not sufficiently appreciated until the recession started.

It is clear that consumers in the US are already more subdued and consumer growth is likely to remain less buoyant – the era of the US consumer being the main driver of global growth actually ended well before the crisis but certainly it disappeared completely in the last couple of years.

The new global driver is China and, collectively, the other developing countries. However, this too poses a risk as much of this momentum relies on China and should China stumble, the edifice of global growth could take a tumble. Although the “imbalance” has changed – and may well curb the old imbalance (ie it may reduce the Chinese trade surplus) – global growth remains at risk as it is overly dependent on one key player. Now it is Chinese domestic demand and households that have become the critical support for a fragile world economic model.

Figure 10: Growing consumption in the developing world



Source: OECD