

Striving for Growth in a perilous environment: an economic outlook

Joseph E. Stiglitz
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Weak global economy

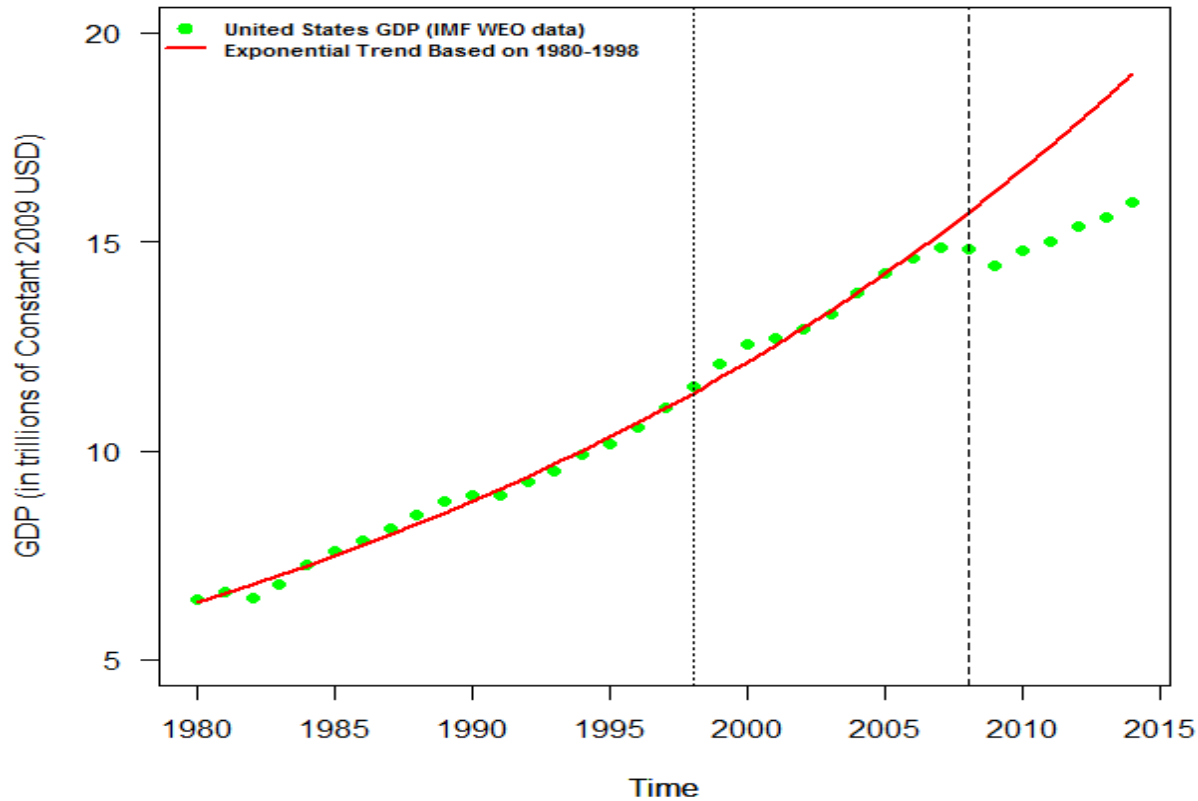
- 2015 slated to be worse year since Global Financial Crisis
- And apart from GFC, one of weakest years in recent decades
- Hope is that 2016 will be better
- But little reason to expect significant improvement

Weaknesses everywhere

- Slowdown in China
 - With knock-on effects especially in those countries dependent on exporting natural resources
 - Most of which failed to take advantage of commodity price boom to adequately diversify their economies
- Continuing weakness in Europe
 - The Eurozone crisis is not over
 - Continuing austerity is having its toll
- Continuing slow growth in US
 - Mild austerity
 - Political gridlock

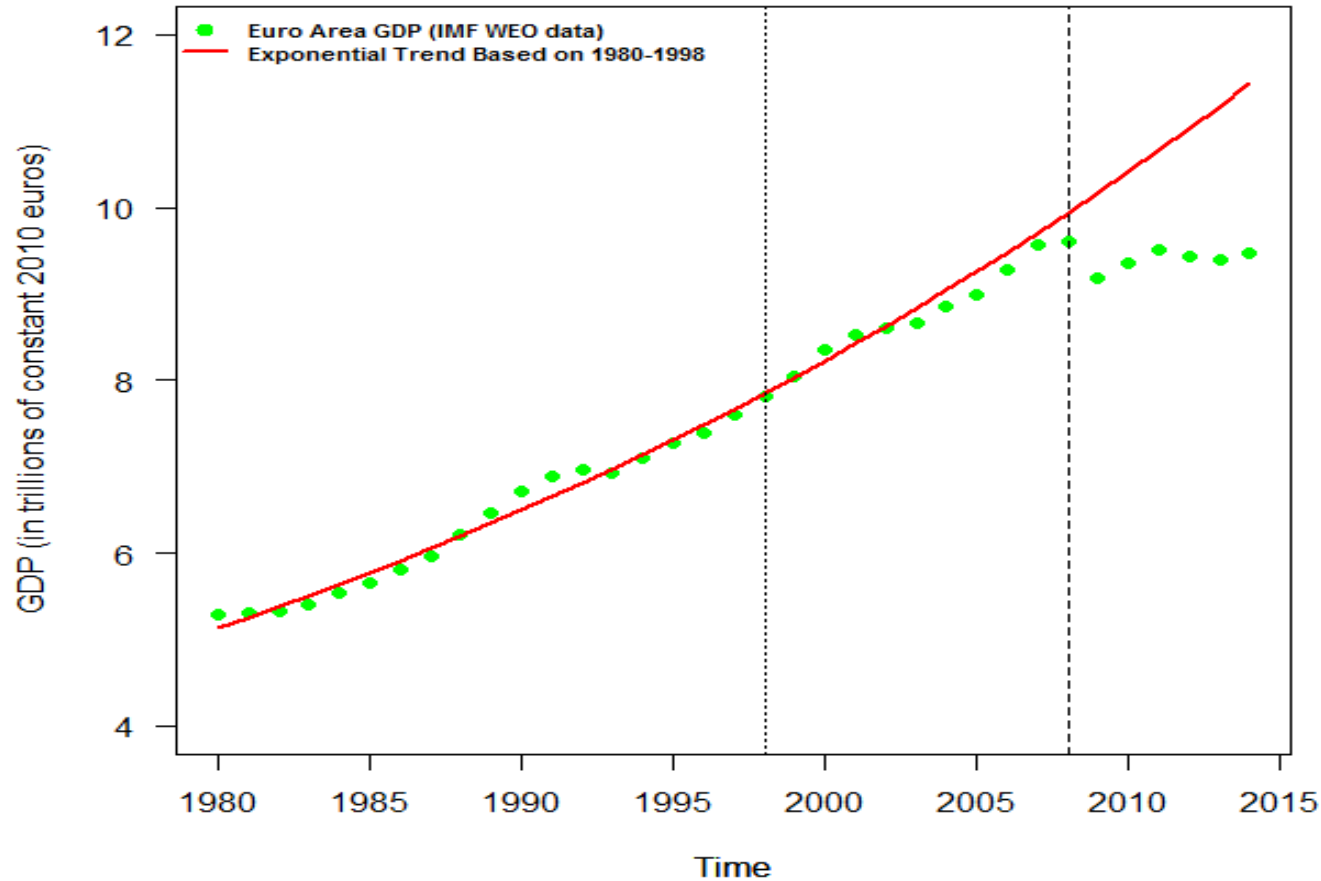
Gap between trend line and actual performance for US large

United States GDP Trend Analysis



Gap between trend line and actual performance for Eurozone even larger, and growing

Euro Area GDP Trend Analysis



Central problem in global economy: lack of global aggregate demand

- Growing inequality in most countries
 - Those at the top consume a smaller fraction of their income than those at the bottom
 - Part of new view: lower inequality is associated with better economic performance
- Widespread austerity—government cutbacks or limited growth
- Structural transformation
 - In advanced countries, in response to technology and globalization
 - From manufacturing to service sector
 - In China, from export led growth to domestic demand driven growth
 - From quantity to quality
 - Markets on their own don't manage these transformations well

Lack of aggregate demand (con't)

- Global imbalances
 - Eurozone has exacerbated problem
- Asymmetrical adjustment
 - Countries (firms, households) facing a decline in income have to reduce consumption
 - Those with increased income do not expand spending symmetrically
 - Response to changes in oil price illustrates

Dysfunctional global financial market

- Standing between long term investment projects (infrastructure) and long term investors (pension funds, sovereign wealth funds) are short sighted financial markets
- Haven't been able to recycle surpluses
- Most of attention in financial sector reform has been centered on preventing financial markets from imposing harm
- Real need to make sure that financial sector performs its critical societal roles
 - Traditional role focused on intermediation and lending to businesses
 - Today, in US, financial sector engaged in disintermediation
 - Leading to lower levels of investment (lower levels of aggregate demand)
 - Level of lending to SMEs very constrained

Misdiagnosis of Great Recession

- Thought that it was just a problem of “sick” financial sector
 - If we just rehabilitated financial sector, all would be well
 - So all that was needed was short term stimulus to help out economy while banks were in “hospital”
 - Didn’t matter much how well the stimulus was designed
- Banks are mostly back to health, but economy still not healthy

Austerity

- View was that reducing fiscal deficits would restore confidence and lead to more investment, returning economy to health
 - No statistical basis in this belief
 - To the contrary: evidence that resulting unemployment undermines confidence
- Austerity has never worked
 - Large number of “experiments” around the world
- Expansionary contractions are a chimera
 - In few “seeming” instances, growth in exports filled void
 - Strong growth of trading partner
 - Facilitated by flexible exchange rate

Balance sheet recession

- View that Great Recession had destroyed balance sheets
 - Would take some time for balance sheets to recover
- Economic activity depends on balance sheets
- But this is *more* than a balance sheet recession
- Balance sheets have been largely restored
 - Large firms sitting on large amounts of cash
 - And yet economy has not been restored back to health

Major consequences of macro-economic mismanagement

- Not only lower growth and higher unemployment today
- But lower output and growth rates in the future
 - What is lost today will never be regained
 - And growth path will be lower
- Estimates of losses in Eurozone *so far* in trillions
- Estimates of PDV of total losses, going forward, are an order of magnitude larger

LA: Striving for Development

- In Latin America, failure to diversify structure of production
 - The region still exports mostly commodities
 - Makes the region highly vulnerable to external shocks

Commodity Dependence and Lack of Export Diversification in Latin America, 2010



Source: IMF, Regional Economic Outlook, Oct 2011

LA: Striving for Development (con't)

- Development strategy for Latin America must ensure three conditions
 - Macro/external consistency
 - Innovation
 - Inclusion—including of the labor force

Satisfying the three conditions will require a diversified structure of production, with multiple strategies for multiple sectors

LA: Capacity for macro policies

- The region is less able than it was in 2008 and 2009 to manage adverse external shocks
 - Because of rising external imbalances (which in some cases led to falling foreign reserves) and in some cases rising inflation; in some countries the capacity for monetary policy is more limited than what it was then
- Most of the countries of the region have switched from running primary fiscal surpluses to deficits, which may limit capacity for expansionary fiscal policies

- Still low external debt ratios
 - Although there is more appetite for borrowing
 - Bond issues by Latin America have gone from \$3.5 bn a month in 2004–07 to \$9.6 bn in 2010–14—with still low costs of financing for countries that issued bonds in international private capital markets
- The few countries that lack access to global private capital markets (Argentina, Ecuador, and Venezuela) have had financing from China
- Some countries may (and probably will) be tempted to use debt to manage the deterioration of the economic situation

- The region overspent in the commodity boom
 - But not sufficiently in economic diversification
 - Recent depreciations of many of the region's currencies will contribute to reduce current account deficits
 - But in the short term, improvements in the current account will come primarily from lower imports, the result of the economic slowdown
- Need for **coordination** of real exchange rate policies

LA: Striving for Development (con't)

- A healthy economic structure should not be so dependent on external factors
- Growing trade with China is not necessarily a blessing
 - China imports almost only natural-resource-based goods from Latin America
 - A structure that is not conducive to innovation
 - And that it does not incorporate much skilled labor (demand side)
 - Hence it doesn't incentivize citizens to invest in human capital (supply side)
 - Many countries were “lazy” to implement reforms that might create a more diversified structure of production

- The region needs to diversify its structure of production
 - Approaches that relied on the market, that were the rule in the 1980s and 1990s, did not work
 - We now have a better theoretical and empirical understandings of these failures
- Macro instrument: **Competitive and Stable Real Exchange Rate Policies**
- Must be accompanied by **industrial policies** and **public investments**
 - And monetary policies that don't stifle the real sector

- The long-term strategy must place technological change and learning at the center
 - It also needs to ensure macro consistency, which requires a balanced strategy that includes traditional activities that generate revenues in foreign currency; and labor intensive activities to ensure full employment of the less skilled population

- It is necessary to diversify trade with China
- Need for better education as part of the broad diversification strategy
 - The strategy needs to ensure there are no bottlenecks in the supply of well-trained workers
 - Requires active state interventions: Markets do not internalize spillovers
- Need for update of infrastructure: investment in highways, ports, and airports
- Public-private partnerships should be designed to ensure an adequate distribution of risks

- The right strategy is more than just increasing exports
 - East Asian export-led growth will not work in current environment
 - Changing role of manufacturing vs. service sector
 - Increased number of competitors
- Poverty reduction and a larger middle class will increase the size of domestic markets
 - Especially important in a development strategy in which domestic demand must play a key role
 - Full employment is the most important part of the strategy
 - Rewriting the rules of the market economy is also critical

- Need for better regional integration
 - North-South agreements often entail rewriting the rules in ways which will lead to more inequality, exclusion, and poor economic performance
 - It requires more political integration
 - At root of Europe's problems is a disjunction between political and economic integration

There will be political and social consequences of Weak Global Economy

- In Europe, high youth unemployment is especially troublesome
- Growth in extremist parties and separatist movements
- In US, anger evident in support of anti-establishment candidates
- In US, large decreases in life expectancy and health
 - Likely to be associated with decreases in productivity
- In LA, the way the less benign conditions are managed will determine distributional effects
 - Which in turn will affect development prospects

Easy prescription: address underlying problems

Government programs to:

- Reduce inequality
- Facilitate structural transformation
 - In advanced countries, key new sectors are health and education, which are especially dependent on government
 - In China, key problems are environment, inequality, urbanization and instability, all of which require more government action
 - Market can't solve the problems it has created
 - Though market mechanisms can be used
 - Deep reforms will be needed to address anomalous characteristics: small share of household income, dependence of local governments on property sales, excessive dependence of economy on credit growth

Global reforms

- Need new global reserve system
 - Current system leads to biases towards surpluses
 - Weaknesses in reserve currency countries
 - China should not want to be a reserve currency
- Need global coordination to reduce global imbalances
 - China's surpluses are in process of being reduced
 - But those in the Eurozone are increasing
 - Will need deep reforms in eurozone
- Need better ways of recycling surpluses
 - New development banks move in the right direction
 - But reforms, expansion of World Bank stymied by US

Finance for development

Could simultaneously recycle surpluses, adding to global demand, and promote development, but there are three impediments

- Debt markets: no international framework for debt restructuring
 - Important initiative at the UN, supported by vast majority of countries
 - But US and some European countries arguing against a “rule of law”
- FDI: investment agreements undermine the ability of countries to regulate
- Taxation of multinationals: international tax regime makes raising revenues difficult
 - Race to the bottom
 - BEPS agreement at G-20 left key issues unaddressed

Action on climate change

Attention on short run problems has resulted in long run problems festering—most importantly climate change

- Investments to retrofit the economy for climate change would provide needed stimulus to global economy
- Environment and economic growth are *complementary*
 - Especially if we measure growth correctly
- Providing a price on carbon would provide incentives for investment
- Success of Paris meeting important for maintaining momentum, so business community realizes that in one form or another there will eventually be a price for carbon
 - Key investments (infrastructure, housing, buildings, power plants) are long term

Key questions:

1. Will the Eurozone make the necessary reforms to restore stability and growth to the Eurozone, or will it carry on with its current approach of muddling through, lurching from crisis to crisis?
2. How worried should Europe be about having a lost decade? A lost quarter century?
3. Will the international community succeed in Paris in creating sufficient momentum that climate investments will begin to be stimulated?
4. Will recent discussions in US and elsewhere about creating financial markets and firms that are less subject to “short-termism” succeed?
5. Are there any grounds for optimism that 2016 will be substantially better than 2015?