



The World Economy: What Now?

Insights on growth prospects and risk factors
for major economies in 2013 and beyond

A Panel Discussion With:

GLENN HUBBARD

*Russell L. Carson Professor of Finance and Economics, and Dean of Columbia Business School
Former Economic Adviser to President George W. Bush*

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Former Chief Economic Adviser to President Bill Clinton, and Chief Economist, World Bank*

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Former US Assistant Secretary of the Treasury*

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THE PANEL:

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MODERATOR:

David Beim

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We make the world significant by the courage of our questions and the depth of our answers, as astronomer Carl Sagan once said. One evening in February 2013, five of the world's leading economic thinkers from Columbia University did a little star-gazing themselves, casting a critical eye on the challenges — and the promise — that exist in an enmeshed global market. Below are highlights from that exchange.

POLICY POLEMICS

The US Fed has applied extreme monetary stimulus in recent years. But real economic growth seems to proceed at its own leisurely pace. Has monetary policy stopped working?

Glenn Hubbard: No. Looking at the Fed's responses early in the crisis, you can think of two buckets: one, a bucket of making markets work better, such as the TALF [Term Asset-Backed Securities Loan Facility] program, where I think most economists would give the Fed high marks. Actual effects on output have been less successful.

A lot of businesses were unwilling to invest even though the cost of capital seemed low. All these quantitative easings raise policy uncertainty: how will the Fed exit this and on what terms?

Credit is readily available at very cheap rates to the largest corporations and to sovereigns. But to entrepreneurs, small businesses, and many households, it's not readily available. So you have a situation where large corporate borrowing is on the rise but, at the same time, the noncorporate sector is being choked up. I think we are asking too much of the Federal Reserve and not enough of the government.

Joseph Stiglitz: You asked whether the Fed has lost its ability to induce increased lending. I don't think it ever had it.

Most of the standard mechanisms through which monetary policy normally operates, including increasing credit availability, aren't working. The mortgage market is still broken. People can't really refinance partly because they are underwater. SME lending, small guys, has always been collateral-based and collateral's always been real estate. The value of real estate is now 30 or 40 percent in real terms below what it was before.

How much longer do you think it will take for the United States to get back to a normal pattern of economic behavior?

Hubbard: Well, it depends what you mean by normal, but the most recent Congressional Budget Office report suggests it's at least five more years to close the output gap we have.

Stiglitz: And I think that's very optimistic.

Hubbard: Very optimistic. The short answer is that it will take a very long time to get back to normal economic behavior. That's not just a clinical answer because that means high joblessness, which is a social problem.

Richard Clarida: Don't forget that the jobless rate is an imperfect measure. If you get decline in the unemployment rate because of a collapse in labor force participation, that's not a successful economy.

President Obama has recently proposed tying the minimum wage to the consumer price index. Will that help get the US economy back on its feet?

Hubbard: I don't think it was a particularly good proposal. The president proposed raising minimum wage to \$9 an hour. Why not \$90? Economists in general are fairly suspicious of minimum wage. I think it's a legitimate goal to supplement the incomes of people who work full-time and don't have a sustainable income. But we should use the tax system to do that through earned-income credits. Higher minimum wages are simply passed along to consumers of particular goods. So the goal is entirely legitimate but the tax system would be a much more efficient way of accomplishing it, at least in my view.

Stiglitz: I would agree with Glenn that the earned-income tax credit is an effective instrument. But the evidence on minimum wage having adverse effects is actually much debated in the economics literature. An important work by Card and Krueger has suggested that there is no negative effect. Obviously, if you increase it from \$7 to \$90 it would have a negative effect, but increasing it from \$7 to \$9 is more likely to have a positive effect. The positive effect comes from the aggregate demand that's produced from the increase in wages.

So, on balance, we're still very cautious about the US economy.

Hubbard: Yes, although there are some bright spots. There is a potential for housing and automobiles to snap back, particularly in an environment of low interest rates. There's good reason for optimism in the energy sector and even in the manufacturing sector. But the level of policy uncertainty clouds it.

THE EUROPEAN MALAISE

Very few people on this side of the Atlantic think the euro crisis is over. It seems that the patient had been sedated rather than cured. What will get Europe out of its slump?

Clarida: I am more optimistic about Europe now. The main reason is Draghi. He's changed the psychology in Europe dramatically. Borrowing costs in Spain and Italy have plummeted by nearly 50 percent, and the European Common Bank has not spent one euro.

There's an old saying in baseball: sometimes you'd rather be lucky than good. But I'll say this: I give Draghi credit. I really think he knows what he's doing.

We've talked a lot over the past decade about global imbalances. The eurozone as a whole essentially is in a balanced current account position. But countries like Spain have had huge deficits. A lot of the inflows were not really adding to productivity but were going to real estate booms and the other usual suspects.

So, it will take a long time to work through that. Obviously, competitiveness is a real challenge in a fixed exchange-rate system. But I think there is now at least some breathing room for European leaders at the country level.

Everybody gives Draghi credit on the financial front, but what about the real economy? What gets the real economy turned around?

Clarida: I agree with the other panelists that it's not all about austerity. You have to do fiscal policy right so that you can actually improve productivity.

I'll give you one fact: for the decade before the crisis, the Italian economy grew by one percent — not one percent per year but by one percent in aggregate over a decade.

You can't sustain the debt levels that many



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—Glenn Hubbard

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—Shang-Jin Wei



of these countries have unless you get growth rates up to around 2 percent per year, or hopefully higher. That will be the medium-term challenge for them.

Hubbard: My concern is fiscal policy in Europe. The European Central Bank can create liquidity. It can create movements in bond prices. But it cannot create a sustainable debt situation.

Too much discussion in Europe is about near-term austerity that is actually deepening the problem. So to say, for example, in Greece that we need an adjustment of 25 percent means that a politician is going to have to tell workers that they must take a pay cut of 25 percent. That's not a popular policy, to say the least.

Don't we risk social and political explosion?

Stiglitz: There's obviously a social and political part of the issue. The leaders have not really diagnosed the problem. They focused on debt. Let's be clear: Greece had a debt problem but Spain and Ireland, two of the crisis countries, had a budget surplus and had a low debt-to-GDP ratio. The economic downturn there, like in the United States, caused the deficit. It wasn't the other way around.

Shang-Jin Wei: The European experience is a good illustration of the point that if a country tends to have an overvalued currency, it's dangerous to have a pegged exchange rate or be part of a currency union. In many other regions of the world — Asia, for example — there's been talk in the past about greater economic integration, including a monetary union. But such talk has been diminished these days by observing the European experience, and that's probably for the better.

Clarida: I think the eurozone has time. But what's really lacking now is strong leadership in individual countries. I think there's too much

focus on centralizing things in Brussels. We need leadership in individual countries because it takes both courage and vision to put in place a policy that, in two, three, or four years, can lead to more productivity.

ASIAN GROWTH HICCUPS

Everyone seems to agree that the future of Chinese growth is to change from an investment- and export-driven model to a consumption model. Is that going to happen?

Wei: The short answer is yes. The Chinese economy is often compared to a three-horse chariot. Horse number one is exports. Horse number two is investment. And horse number three is domestic consumption.

To borrow from popular imagery, the first two horses are oversized, perhaps on steroids, and horse number three, consumption, is a dwarf and perhaps even stunted intentionally by government policy.

I think there are quite a few things wrong with this image. For one, there's nothing wrong with having high export potential. Indeed, looking into the future, I think it would be beneficial for China to maintain high exports. It is the exports minus imports that cannot grow forever.

On the investment front, there's still a lot of room for growth in absolute terms. The primary problem is not so much the level of investment but the structure of that investment. China needs to improve its financial system so that more capital — both domestic and foreign — can be reallocated away from the less-efficient majority-state-owned entities and toward the more-efficient privately owned entities.

On consumption, let me say this. Contrary to popular opinion, Chinese consumption has been growing extremely fast if you look at per capita real consumption after adjusting for inflation over the last seven years. Chinese per capita consumption in real terms has increased by

about 80 percent. Virtually no other country in the world has exhibited this large an increase. Of course, Chinese GDP has grown by more than 80 percent during that same period, so the ratio of consumption relative to GDP is not holding up.

What's the hope that the consumption-to-GDP ratio can be raised?

Wei: Three things are needed: first, to improve the social safety net in order to reduce precautionary savings. Second, to improve income distribution so that people, especially in lower-income segments of society, have money to consume. And three, to reduce competitive savings triggered by a sex-ratio imbalance.

The government has acted on the first one — a better social safety net — with some success. The government also has lots of pronouncements and initiatives on the second one (a more even income distribution), but some of the policies, such as an increase in the minimum wage, could backfire if they make firms less willing to employ low-skilled workers.

The government has not sufficiently recognized the role of competitive savings yet. A relaxation of the family planning policy or a stronger incentive for parents to have girls may be needed on that front.

So how can government raise the relative share of consumption of GDP? What about raising interest rates?

Wei: Well, some of my friends in Washington, DC think tanks think one reason underlying Chinese high savings is artificially depressed real interest rates. I don't share that view.

Higher interest rates have two competing effects on savings. When you raise interest rates, it might give people a bit more income and they might consume more. But it also makes saving more attractive than

consumption. So, in response to higher interest rates, savings may go up. Evidence suggests that this is indeed the case.

José Antonio Ocampo: By raising interest rates, you don't increase savings. There is massive literature on that in the emerging economies. I don't think it works in general.

Hubbard: To me, the bigger story in China is about efficiency in financial intermediation, moving money from savers to borrowers. There's not yet an intermediation system that would support a huge consumption sector. That system would facilitate improvements like a better mortgage market.

LATIN AMERICA: A ONE-TRICK PONY?

In the past, many Latin American countries have grown in cycles. They've had bursts of growth and then some event — a change of politics or in financial markets — suddenly stopped things. Will we see that pattern again, or does the recent growth in Latin America seem likely to continue?

Ocampo: Let me say that I find it wrong to focus on the last decade in Latin America because there were many distinct phases. Between 2003 and 2007, it grew 5.6 percent per year on average. Later on, it slowed down significantly. This year, everyone expects around 3.5 percent, so growth is not very good.

It will not grow very fast above current levels unless it starts to really catch up technologically and invest more in research and development as a proportion of GDP.

Clarida: One thing I have observed about Latin America is that there has been a dramatic transformation in policy credibility and accomplishment. But there have been some important tailwinds. Most of that region's major countries are commodity



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—José Antonio Ocampo



(left to right): David Beim,
Joseph Stiglitz, Glenn
Hubbard, Richard Clarida,
José Antonio Ocampo,
Shang-Jin Wei

exporters. You're in a period where commodity prices are elevated relative to historic levels, and I think the most likely scenario is that they'll stay that way.

Ocampo: That generates the tendency to appreciate their currency and forget about diversification of the production base. We have not been investing in the technology-intensive sectors that will allow Latin America to catch up and to benefit from high growth after the commodity boom stops.

Wei: There's an interesting Latin America-China connection I would like to suggest.

There are, roughly speaking, two Latin Americas. The first consists of those countries that essentially produce things that China buys, such as Brazil or Chile. The second Latin America is those countries that are not

commodity producers but they produce and export things that compete with China. Mexico is one example.

When the Chinese economy was booming, in the last decade or so, the first Latin America — essentially, the major commodity producers — was doing extremely well. But some of those countries neglected to develop their noncommodity sectors, which in turn raises concern when there is a Chinese slowdown.

The second Latin America has relatively few commodities to export. Because they more or less produce and export things that China also produces and exports, they compete with China and find themselves squeezed in the world market because they tend to have a higher labor cost and poorer infrastructure. One thing these countries have to do is to upgrade their technology and move up the value chain.

There's another sense in which there are two Latin Americas: one with healthy economic and political institutions and another with less healthy institutions. What are the prospects for the weaker regions?

Ocampo: I don't agree with this division of Latin America. Some of the less orthodox economies have been doing well. For example, Argentina in 2011 was a very fast grower, as was Ecuador. Brazil is considered to have orthodox institutions but has been doing very poorly. So really, the political division doesn't match the economic performance.

AFRICA: GEOGRAPHY AND DESTINY

Africa seems to be winning the prize for the most improved student in the class. Is this the brightest growth spot we've got?

Stiglitz: It is markedly improved but it was starting from a very small base.

But that makes growth more feasible.

Stiglitz: Yeah, the growth is still not as good as, say, China. Let me give a little perspective on what has happened. One view is that, beginning around the 1980s, the IMF put in place a series of policies that were devastating for Africa. It led to the deindustrialization of Africa. Today, the fraction of employment in industry is lower than it was 30 years ago.

Now they recognize that industrial policies are a good thing. They've done a lot more in terms of macroeconomic stability and improvements in governing.

All of this has been change for the positive. And it's not just the natural resource countries that have done well. A country like Ethiopia, which is landlocked, is one of the fastest-growing countries in the world. Some people, including here at Columbia University, have written that countries which are landlocked and mountainous have poorer economic prospects.

That's a very gloomy conclusion.

Stiglitz: Geography is not destiny. The late prime minister of Ethiopia used to get very angry when people would make this argument.

Another example is Botswana. For 30 years, it was the fastest-growing country in the world.

Stiglitz: They managed those resources very well. On the negative side, even the countries that have done everything right in terms of the standard prescription have had difficulty attracting foreign investment outside natural resources. Western companies are willing to come in and take people's resources out if they do it cheaply but they've been so far relatively reluctant to come in and make real investment.

On a more positive note, there's concern about governance and, I might say, bribery. But for every bribe, there's a briber, and the briber tends to come from the advanced industrial regions including the United States and Western Europe.

Hubbard: Concerning governance, part of the issue in attracting investment outside the extractive sectors is the creation of property rights, rule of law, independent judiciary, and the ease of starting complementary entrepreneurial businesses. Africa is a place with many different countries, but there's a big variation in what the World Bank measures in its 'doing business' indicators, which is a summary measure. Over the last decade, US policy has tried more to condition foreign assistance on governance improvement. I think there's room for improvement there. ■



WESTERN COMPANIES ARE WILLING TO COME [TO AFRICA] AND TAKE PEOPLE'S RESOURCES OUT. BUT THEY'VE BEEN RELUCTANT TO COME IN AND MAKE REAL INVESTMENT.

—Joseph Stiglitz

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