New Economic World Order: Perspectives from the U.S.

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Flims
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Where are we?

• Pulled back from the brink on which we seemed to be poised two years ago
• But economy is still weak
• With growth likely to slow in second half of 2010 and 2011
  – Even in optimistic forecasts, too slow to reduce unemployment significantly
Where are we?

Percent Change From Preceding Period in Real Gross Domestic Product
Seasonally adjusted at annual rates
Source: Bureau of Economic Analysis Table 1.1.1
Labor market

• Official unemployment stuck around 9.5%
• Broader measure worse—one out of six Americans who would like full time job can’t get one
• For first time, almost half of unemployed are long-term
  – Labor market flexibility by itself is not sufficient to ensure well performing economy
  – Weak labor market part of negative cycle—contributing to weak aggregate demand
Other continuing weaknesses

• Foreclosures continuing apace
  – Administration programs ineffective
  – One out of four mortgages underwater
  – 1.65 million foreclosures in first half of 2010—faster pace than 2009

• Analogous problems in commercial real estate
Other continuing weaknesses

• Contributing to problems in banking
  – 140 bankruptcies in 2009
  – Even more are likely in 2010
    • 119 already as of September
  – Many other banks in trouble
    • Increasing number of FDIC “Problem List”
      • 829 on list in second quarter 2010, up from 702 at end of 2009
  – Large bank profits associated with trading, not lending
Other continuing weaknesses

- Lack of access to credit, especially for SME’s
  - Even though banks have access to low cost capital, interest rates they charge high
  - Value of collateral reduced markedly
  - Bank credit remains weak: annual growth rate in 2010Q1: -7.6% and 2010Q2: -5.9%
Other continuing weaknesses

Figure 1.3. Bank lending remains weak
Year-on-year growth rate

Source: OECD Economic Outlook No. 87, May 2010.
Other continuing weaknesses

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Other continuing weaknesses

• State and local government (accounting for a third of all government expenditure) facing major shortfalls
  – Balanced budget framework means that have to cut back spending
• End of stimulus
  – Little appetite for another stimulus
  – Political conflict over form of stimulus may result in now stimulus or a poorly designed one
Other continuing weaknesses

The Total Deficit or Surplus, 1970 to 2020
(Percentage of gross domestic product)

Source: Congressional Budget Office.
Other continuing weaknesses
Biggest risks going forward

• Biggest problem: lack of adequate aggregate demand
  – What sustained economy before crisis was bubble
  – Savings rate fell to zero
  – Unsustainable
  – What will fill the gap?
  – Government assistance temporary palliative
The challenge of reducing unemployment

- With labor force growth of 1% and “normal” productivity growth of 2 to 3%, growth is too small to provide jobs for new entrants—unless economy grows 3 to 4%.
- As weak economy continues, individuals lose skills, loss of human capital
- Risk of a “new normal” with high sustained unemployment (hysteresis effect)
- Problems in housing market exacerbate this fundamental problem
  - “Flexibility”—ability to move around country—had been one of strengths of American labor market
  - With low or negative equity mobility reduced
The challenge of reducing unemployment
An export led recovery?

- Some increase in exports recently
- But too small to be the basis of recovery
- And stronger dollar and a weaker Europe may make continued growth less likely
  - Europe’s economy is especially likely to be weak if many countries adopt austerity packages
    - Long history of “Hooverite policies”—they almost never work, few apparent exceptions growth not because of austerity, but related to expansion of exports
    - Whole world can’t export their way out of crisis
- China’s exchange rate not key problem
  - Even if it appreciates, it will not have major impact on US multilateral trade deficit
Exchange rate volatility

• But the world is likely to be marked by high exchange rate volatility
  – Uncertainty bad for investment
  – Exchange rates like negative beauty contests
    • Right now the focus is on Europe’s fiscal problems
    • But attention is likely to shift at some time to US problems
      – Fiscal deficit
      – Hidden pension deficits in states
      – Political gridlock
      – Other economic problems
Risk of protectionism

• As scope for fiscal policy narrows, monetary policy proves ineffective, and economy remains weak, likelihood of growing protectionist sentiment
  – Exacerbated by successes in Asia
  – Already evident in measures against China and India
Risks of monetary policy?

• Some worry that continuing low interest rates, quantitative easing will lead to inflation
  – Unlikely, given excess capacity
  – Real challenge: *if and when economy recovers, can Fed drain excess liquidity from economy in such a way as to prevent another downturn and an onset of inflation?*
    • Fed’s record should not give us much confidence in their ability to manage

• Longer term risk of quantitative easing: large capital losses for government
Risks of political gridlock?

- Democrats want infrastructure, extended unemployment coverage, programs for small businesses, extension of middle class tax cuts
- Republicans want extension of tax cuts for upper 2%
  - Country can’t afford, and couldn’t afford when they were enacted
  - Evidence is that they would stimulate the economy very little
The structural challenge

• Several important sectors need big adjustments
  – Housing, real estate—overbuilt in many parts of country
  – Finance—needs to be downsized (help finance real estate, credit card practices being circumscribed)
  – Health care—reforms unlikely to affect soaring costs
  – Manufacturing—successes in productivity growth, changing comparative advantages mean that employment will likely decrease
The structural challenge

- Source of strength—education, hi-tech—not big enough to compensate for weaknesses elsewhere
  - Universities facing financing problems
  - Visa restrictions
  - Financial crisis has hurt venture capital firms
The medium to longer term prognosis

• U.S. mired in Japanese-style malaise
  – Perhaps with slightly higher growth (higher labor force growth)
  – But greater inequality, weaker social protection
    • Most Americans have seen a decade of declining real incomes
  – Exacerbated by difficulty in coming to terms with its standing in the New Global Order
    • High growth in Asia
    • Extension of Asia’s influence in rest of world
    • Weakening of “soft power”
    • Questioning of relevance of “hard power”
A new global economic order

• No longer dominated by one “superpower”
  – Though China’s income per capita will remain much below that of the U.S.

• New thinking about alternative political and economic models
  – Crisis raised questions about long standing views of economics
  – Conflict of ideas will be particularly strong in developing world

• Greater difficulty in reaching global agreements
  – Evident in Copenhagen