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Economic Viewpoint

Notes by Danny Leipziger*

The Different Paths of Economic Recovery

Much is written about the shape of economic recovery from the economic collapse of the last 18 months. And even though unemployment is still alarmingly high, and observers see a structural shift that unfortunately does not portend well for the net creation of new jobs, there are signs of recovery in all parts of the world. These recovery trajectories differ, however.

The situation in Asia is one of a slightly less booming economy, but still robust growth, led by China, where domestic demand was successfully substituted for dormant export demand, albeit with an implicitly subsidized exchange rate. For the East Asia region, China and Korea continue to pull up growth prospects, and in the case of Korea, the shape of the recovery is a clear V for Victory over the crisis.

In the U.S., and to a lesser extent the U.K., the recovery has been slower and investment is still sluggish based on unavailability of credit, with banks padding their balance sheets with government paper and trying to de-leverage, and an uncertain outlook for consumer demand. With asset rebuilding leading increased savings, there is not much appetite for expansion and/or innovation. The only component of aggregate demand that is really expanding is government spending, and this obviously is not sustainable. Nonetheless, unless there are major miscalculations, the recovery should proceed with a gentle soup-bowl kind of U shape as in U for Uncertainty.

Well what then about the feared W or double whammy of a second recession? Where is this most likely to occur, if at all. Ironically, one might argue that it is most likely in Europe, even though the downturn has been less pronounced in continental Europe and the recovery, largely export led in Germany, for instance, has been swift. Why the risk of another downturn? Largely the risk comes form the actions of the European Central Bank (ECB), the inflation watch-dog central bank that sees inflation as its greatest threat, even in the aftermath of this unprecedented economic collapse. Were the ECB to tighten up its monetary stance at the first hint of inflation, then the combination of continued exchange rate appreciation and higher rates could abort the recovery and cause a drop in economic growth. This could produce a W for Western Europe.

What can we expect in terms of globally balanced growth, the new stated objective of the G-20? Frankly, unless China changes its policy objectives and allows the currency to appreciate , imbalances will return, although perhaps to a lesser degree, since American consumers cannot afford to eschew savings as in the past. Demand will continue to be brisk in Brazil, driven by a diversified economy, and in India, driven by capital inflows and an expansive fiscal posture. Russia will continue to be dependent on oil prices in its growth path. So, we are left with the G2 and Europe, each with its own policy objectives.

The US needs to create jobs, rebuild assets, finance health care and wars, and still manage to reduce its deficit. This is a difficult task and will imply higher interest rates and ultimately higher taxes, not a recipe for high growth. Europe will continue on its low growth and low inflation path. China will face bottlenecks in its hyper-growth economy, a possible bubble that will chew up reserves once it bursts, which may be inevitable when countries tire of the beggar-thy-neighbor exchange rate policy and exports begin to level off. What shape this will reflect remains to be seen. It's not a rosy picture overall.

What can either ameliorate or worsen this scenario is the way in which countries approach trade issues in the next 2-3 years. If competitive devaluations become commonplace, and surplus nations insist on running them, it will prove difficult to resume any kind of normalcy in economic growth. Decades of fairly open access that boosted export-led economies will be threatened. Much of the leadership for openness now passes to those who benefitted most from free trade in the recent past, namely, the new economic powers, and how this is exercised will in large measure influence the long-term trajectory of global recovery.

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