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The Future will be better tomorrow

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"It is difficult to make predictions, especially about the future."

No-one can agree who said that first. It has been variously attributed to the American baseball player-philosopher Yogi Berra, the Danish physicist Niels Bohr, and the movie producer Sam Goldwyn. How true it is, though. At the start of this New Year it is especially difficult to make predictions for the global economy because of the many unknowns out there: a US election in November, a French election in the spring, a possible change in the Chinese administration, Persian sabre-rattling in the Straits of Hormuz, the nuclear-armed hermit kingdom of North Korea under new management.

But not predicting does not mean not trying to understand the longer term economic trends. So as the year starts we will tease out unfolding events in the three most important economic regions, events that I believe are likely to be cause for concern over the coming year and will shape our future.

The American dilemma

One of the most remarkable things about the US economy as it has come out of the depths of the 2008-2009 financial crisis is the dramatic improvement in firm productivity. Firms seem to have shed unproductive jobs and plant, and taken advantage of unemployment that is at historically high levels to squeeze wages, improving their overall cost structure. Lower dollar production costs, aided by a weaker dollar compared to the US's chief trading partners, have led to increased exports and an improved current account deficit, which before the crisis was running at about $60 billion per month and has now come down by a third. Corporate profits are high. Historically the United States has been much better than Europe at reallocating economic resources in the economy following a downturn, and this crisis is no exception.

But dark clouds are massing on the horizon. The first of these is that unemployment remains stubbornly high, particularly long term unemployment. Real estate still remains a deadweight on the economy, as millions of home-owners are "under water" (owe more on their mortgage than their home is worth) which reduces their job search mobility. The trend of greater income

[1] Quotation attributed to Dan Quayle, US Vice-President to President George H.E. Bush.

inequality, which has been noted for over a decade, has accelerated again, and the "Occupy Wall Street" movement is crystallizing national dissatisfaction with the bankers and the "1 percent", the wealthiest who have garnered the bulk of the fruits of economic growth over the decade. The United States now has less social mobility than Europe.

At the federal level, public debt exceeded 100% of GDP in 2011 for the first time since the Second World War, largely the result of the federal response to the financial crisis. The budget deficit also remains at an unacceptable 8.7% of GDP, twice as bad as Italy and similar to that of France.

The most worrisome issue, though, is the inability of the US congress to agree on the strategy to set things straight. The Republican Party is in thrall to the "Tea Party" wing which wants only to cut expenditure and social programs without resorting to raising taxes.[2] On the other side of the political divide, many Democrats in Congress believe that the problem can be only solved by raising income taxes on the wealthiest, without touching the sacred cow of entitlement programs. In practice, a combination of both of these will be needed to get the federal budget deficit in order. The general public is exasperated by Congress's inability to govern, and its approval rating – now down to single digits – is at its lowest level in history. And the timing could not be worse: in 2012 the United States is in the midst of a Presidential election, a particularly inauspicious time for Congress to agree amongst itself or with the Executive branch on a sensible policy based on pragmatic solutions to America's problems.

In 2012 therefore, we should expect more congressional posturing and dueling with the White House over the budget, particularly over tax increases as the Bush tax cuts reach expiration at the end of 2012. Budget and tax issues, combined with the Euro crisis (see below), could endanger the sputtering recovery and exacerbate public dissatisfaction. The US is in dangerous waters, and the crew members are fighting among themselves on the bridge.

The Euro Crisis – the never-ending story

Watching the Eurozone crisis unfold holds all the horrifying and voyeuristic fascination of watching a railroad wreck take place in slow motion. You know it's not going to end well; it's going to be awful to watch; but you just can't look away. The causes of the crisis have been described elsewhere, as have the misguided measures taken by Eurozone politicians to try to stem the rot. One thing is certain: the crisis is far from over. But how will it end?

If any of us knew for certain how the Eurozone crisis would unfold, we would become exceedingly rich. But whatever Chancellor Merkel and President Sarkozy think, the markets are

[2] An absurd example of this was the bitter stand-off over raising the federal borrowing ceiling in July 2011.

now in the driving seat, and the markets don't like what they see. The markets are not amused by needlessly harsh internal adjustment programs in the countries with unsustainable debt burdens (which are more likely to lead to social unrest than to fiscal probity); they want to see clear mutualisation across the zone, endorsed by an explicit lender-of-last resort role for the ECB[3]; and they want to see European economic programs that will lead to resumption of growth, not to deeper recession. Over the past year European politicians have failed to deliver on all counts.

Despite the view in popular imagination in some European countries, "The Market" is not made up of some shadowy conspiracy of traders and rating agencies plotting to bring down the European social project by shorting sovereign bonds. This view is self-serving but ultimately wrong. To a very large extent the bond market is made up of investors who are not investing their own money. These investors have a fiduciary responsibility to invest the money they manage on behalf of other people as wisely as possible, and not take undue risks. This means that when a country like Greece, Italy or Spain issues a new sovereign bond to refinance a previous bond that has come to term, some of the investors will not participate in the new issue even though they might have in the previous round. The lower overall demand for the new bond means that its price is lower and the resulting yield is higher, so the government now has to pay a higher interest rate on the new issue than they did on the old one. This is the situation in the European peripheral countries; higher interest now means that the debt is more difficult to service, and the country correspondingly more fragile. Unlike Europe's politicians, the markets may be brutal but they are brutally honest.

On Friday January 13, 2012, Standard and Poor's, a credit rating agency, downgraded the credit ratings of nine Eurozone countries.[4] This move by S&P was criticized by several Eurozone officials. The downgrade, however, will not be the cause of higher interest rates. It is the effect – the recognition of a situation that has been clear to all who deal in European sovereign debt. Europe's politicians have not so far handled the Euro debt and deficit problem in a manner likely to achieve an outcome suitable for the countries concerned. The situation has not gotten better. It has gotten worse.

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[3] The ECB is very fortunate to have Mario Draghi as Governor to replace the Teutonically inclined Jean-Claude Trichet. Although the ECB is not allowed by its mandate to purchase sovereign bonds directly, Mr. Draghi's €500 billion injection of credit into European banks has done wonders, not only to decrease the risk of a credit crunch within the European financial sector, but also to shore up the European sovereign bond market.

[4] France's valued rating of AAA (the highest possible) was cut to AA+. In practice the effects of this cut on the French cost of borrowing will be slight, as AA+ is still a very good rating indeed. (S&P cut US federal debt to AA+ in 2011 following the debt ceiling debacle.)

There are three ways this railroad wreck could unfold over the coming year, which have been discussed at length elsewhere. The first (and most optimistic) outcome is that **Europe's politicians would finally get it**. Under this scenario they would extend enhanced debt support to peripheral sovereigns and banks and issue a comprehensive guarantee, via the ECB, to ensure the creditworthiness of the entire zone that will finally be credible to the markets. They would drop their moralizing punishment of the profligate peripheral countries, particularly Greece, as this policy is leading only to a slump in growth and increasing social pain and unrest. Instead they would launch a region-wide growth plan – with strict budgetary monitoring across the zone – which would include amongst other things, looser credit terms in Germany to promote domestic consumption, less restrictive monetary policy across the zone to bring down the value of the Euro compared to Europe's trading partners, and Europe-wide labor market reform to achieve greater international competitiveness and mobility in the medium term. They would also start to tackle the unsustainable pattern of public expenditure in Italy, Greece, Spain, Portugal and France.[5] Under this best-case scenario, the Euro would emerge strengthened as a currency – albeit at a lower exchange rate to its competitor currencies – and the Eurozone would move toward a stronger, more integrated federation.

The alternative is that things continue as they are going now: **more of the same**. Under this scenario, we continue to have tight monetary policy and a strong Euro. The Eurozone recession would be deep and long, with increasing social unrest across Europe. The Troika of the EU, ECB and IMF would continue to impose harsh internal adjustment programs on countries needing financial support. The European coalition would start to fray, as the split between Germany and the northern Euro countries on the one hand, and the Southern Euro countries on the other, widens. Under this scenario the Euro would survive as a currency, at the cost of European cohesion and social peace. An extreme outcome would be the **breakup of the Euro**, which would occur if one or several countries considered it simply too difficult to maintain the conditions necessary to remain in the zone and would leave – or be asked to leave.

Make no mistake: the costs and disruption of a breakup of the Euro would be very great. The shocks across the financial sector, not only in Europe but in the US and in the emerging economies, would be immense, and would certainly lead to a deep worldwide recession. This is not a good outcome, but has the merit of focusing the minds of the European politicians.

[5] In France, in particular, there is a distinct preference to raise taxes rather than cut expenditure. The most recent example is the so-called "Social VAT" introduced in December 2011. As VAT is the most regressive of taxes, this name is ironic – it should instead be called "Antisocial VAT" as it will hit the poorest hardest. There is now discussion of the introduction of the "Tobin Tax" (a tax on financial transactions) as well. However, as the total share of taxes and social levies in France exceeds half of GDP, there is clearly little space left to continue to raise taxes, and costs will eventually have to be cut.

Will the Chinese bubble burst?

It goes without saying that the Chinese miracle of the last quarter-century is one of the most astounding economic feats of history. The economic reforms that were introduced in China starting in 1981 have led to the longest sustained growth spurt of any country in the historical record, one that has lifted more people out of poverty (at least 200 million) in less time than any other economic revolution, and which will return China to its rightful place as biggest economy on the planet by around 2025. (It is already second – or third, if you count the EU as one economy – after surpassing Japan in 2010). This is the position it held up until about 1650.

The manner in which the Chinese reforms were implemented started with greater openness to the rest of the world, initially through the creation of autonomous economic zones, which launched a sustained export push. Competition was introduced among state owned enterprises and between cities and regions. A managed currency regime provided predictability and (some say) export competitiveness. The massive savings rates of the Chinese state and its citizens financed – amongst other things – major investment in public infrastructure. Whatever the details, the reforms had the overall effect of moving the Chinese economy much closer to its "production frontier", which is the economists' way of saying that the Chinese economy became much better at combining the inputs of capital, labor and raw materials to produce products and services of value. China became the factory to the world, the role Britain had occupied during the Industrial Revolution.

This miracle would not have been possible without the United States as willing accomplice. Just at that time in its own history, the US was outsourcing significant segments of its lower value-added industry to low-cost Asian producers and opening its markets to their products in return, as part of the global trade liberalization within the framework of the World Trade Organization. It is an oversimplification – but not entirely false – to say that the US trade deficit resulting from these increased imports was financed by the savings in Japan and then China, through acquisition by these countries of dollar-denominated Treasury bills and bonds.[6]

Any visit to the cities in the south and the west of China today will attest to the extraordinary revolution that is taking place in the country. The ultra-modern infrastructure endowment alone is in sharp contrast to that of a mature country like the United States, with its crumbling bridges, creaky rail network, and crowded, untidy airports. The young Chinese workers in these modern

[6] Of course it's more complicated than that. The US trade deficit has gone hand in hand with a persistent budget deficit dating from President Nixon's term in office (with the exception of a short period toward the end of President Clinton's second mandate) and to increasing household debt. Households have borrowed more because of an expansionary credit regime, which eventually led to the most recent financial crisis. An overly expansionist monetary policy over the period 2002 – 2008 did not help either.

cities seem as similar to their parents as South Koreans are to North Koreans; and their consumption patterns are beginning to emulate those of the youth in Western countries and Japan. Unlike the young populations in North Africa, there seems to be no broad-based movement for greater political freedoms. The superficial view is that the new generation of Chinese has been raised on a diet of regular double-digit economic growth, in exchange for social peace.

But all is not well in the Middle Kingdom. Growth has not been a tide that has raised all boats. People in the center and east of the country have remained mired in poverty, dramatically exacerbating the inequality across China. Housing construction in the cities has been accompanied by credit expansion and rising real-estate prices, leading to a classic property bubble – but unusually, one that has occurred in the face of unoccupied new housing. And most importantly, the Chinese economic machine, for long based on export-driven growth, has run its course and will no longer be able to deliver the growth rates that the new generation has come to expect. The industrialized countries have lost their taste for debt-fueled consumption and can no longer be the market for China's products.

Moreover, Chinese policy formulation faces a further complication. This year, a change is expected in the most senior positions of the administration. The current Chinese collective leadership made up of Hu Jintao (General Secretary of the Chinese Communist Party) and Wen Jiabao (Premier of the State Council) is expected to be replaced by the "Xi-Li" administration with Xi Jinping and Li Kegiang in these respective roles. How well will the new administration chart the choppy waters ahead?

Impossible to say. The better of the two possible outcomes is that the new leadership will gradually reorient Chinese production away from exports and publicly funded infrastructure to satisfying growth in domestic consumption, which would in part mean revaluing and liberalizing its currency. At the same time the government would need to cool the overheated property market and continue to rein in the expansion of private credit. It would reinforce transfer programs to less privileged regions to provide a social safety-net for the most vulnerable and offset the growing income inequality. This range of policies would lead to a soft landing for the Chinese economy, and a new growth trajectory for the country based on domestic consumption.

The path that we should wish to avoid is that the Chinese property bubble would burst just at the time that growth stalls. This would lead to increased inequity, unhappiness and unrest in China and would upset the very delicate geopolitical equilibrium that China has built up over the past quarter century, an imbalance which could ultimately have dire consequences.

2012: the year of all the dangers

I wish I could wish us all a Happy New Year, but circumstances do not allow. History does not proceed in a linear fashion; there are certain hinge moments when multiple paths are available, multiple outcomes are possible. At these moments our decision-makers set us on a path that defines economic and social outcomes for decades to come. Examples of such hinge moments include the weeks following the assassination of Archduke Franz Ferdinand of Austria in June 1914, when the inability of European leaders to come to terms led to the First World War; the months following the Great Crisis of 1929 when the flawed reaction to the crisis led to the Great Depression; and perhaps the period following the September 11th attacks when the US response in the Middle East was mapped out. We may be at such a moment again now. It has never been more difficult to predict the future.

