How to do better than the ‘new mediocre’

By Martin Wolf

We must launch well-crafted reforms in both emerging and high-income economies

Are we to believe that slower growth in the world economy is here to stay? Christine Lagarde of the International Monetary Fund thinks so; “the new mediocre” is the managing director’s disheartening term for what she sees as the new normal. The worsening forecasts published in successive issues of the World Economic Outlook support her view (see charts). Significantly, while the performance of high-income economies has been poor, especially in the eurozone, in the medium-term it is the emerging economies whose prospects appear bleakest.

Yet disappointments need to be kept in proportion. If average annual growth of emerging economies were to remain over 5 per cent, their output would double every 14 years. This would mean rapid increases in the standards of living of a huge proportion of humanity. An additional source of good cheer is that the economies of emerging Asia are expected to achieve growth of 6.5 per cent this year and 6.6 per cent in 2015. This is no small matter, since emerging Asia contains half of humanity. The IMF has made no downgrade of its forecasts for emerging Asia since last April. In addition, the second-fastest growing region is sub-Saharan Africa. Its growth is forecast to be 5.1 per cent this year and 5.8 per cent in 2015. Since these two regions contain nearly all of the world’s poorest people, this performance is of far wider human significance than are the disappointments elsewhere.

The worry, however, is that the downgrades might continue into the more distant future. One reason for believing this will not be the case is the scale of recent disappointments. The Russian economy, for example, is stagnant. Performance of the Latin America and Caribbean economies is little better, with growth forecast at 1.3 per cent this year and 2.2 per cent in 2015. It is always possible for these economies to do still worse: Vladimir Putin’s embrace of a hostile relationship with the west may make that quite likely for Russia. But substantial upside potential also exists.

The trouble is that the IMF’s medium-term forecasts already assume such a rebound in emerging economies. It fears that this hoped-for rebound might not occur, because of a “lack of action on structural constraints…, a tightening of global financial conditions, a slow pace of recovery in advanced economies or any combination of these factors”.

The IMF adds that China’s economy might suffer a bigger slowdown than now assumed. This would probably be due not to a financial crisis (which should be avoided), but a failure to replace the demand lost when unsustainable credit booms subside. This, after all, is what happened to the high-income countries after their credit-driven growth came to a halt seven years or so ago.

The WEO stresses the medium-term risk of low potential growth and “secular
stagnation” in high-income economies. The former means weak growth of supply. The latter means structural constraints on demand, including a rapid contraction of credit in vulnerable countries. (See chart.) A feedback relationship exists between the two: weak growth in demand saps confidence and damps innovation and investment. When growth is expected to be slow, private consumption and investment falter. Such a spiral is to be seen in the eurozone, where real demand is 5 per cent below its pre-crisis peak and deflationary risks are high. Ultra-low inflation, let alone deflation, exacerbates the burden of debt.

In the US, where balance sheets are no longer so constrained and there has been at least modest growth since 2009, the economy might now start to accelerate. Among the other drivers of such growth would be cheap energy, a pick-up in investment and a recovery in household formation, which has been running at about half its pre-crisis levels. This would be unlikely to produce the kind of untoward jump in inflation that would force the Fed to apply the brakes. With the world economy weakening and oil prices falling, inflation should not be a real danger. The Fed should tighten slowly — and this is unlikely to create problems for economies outside the US.

The position of the eurozone is, alas, different. Germany, its most creditworthy country, remains dependent on external demand. It is also largely opposed to the unconventional monetary policies that might stimulate that demand. It is even more opposed to potent fiscal policies, either at home or across the eurozone. It is even more opposed to potent fiscal policies, either at home or across the eurozone. It hopes that the magic of “structural reform” will awaken the animal spirits – although its own structural reforms in the past decade awakened no such spirits at home.

At Berlin’s insistence, the eurozone has turned into a battleground for meagre scraps of demand, under the rubric of “competitiveness”. This inability to move beyond the intellectual framework of a small open economy to a continental one is a tragedy. A renewal of the crisis is possible, given the risk that bond yields – now subdued – will again begin to climb.

It is important not to exaggerate the story of slowdown in the world economy. Yet it is also vital to avoid a progressive downward slide in growth. To address this risk, it is necessary to launch well-crafted reforms in both emerging and high-income economies. In the latter, the biggest challenges are inside the eurozone, where the failures to craft a balanced economic strategy remain both egregious and very dangerous. As the IMF argues, there is also a powerful argument for more public investment in infrastructure. This could pay for itself and so lower rather than raise public debt, in today’s circumstances of weak growth and ultra-low real interest rates.

It is vital to craft strategies for growth that neither ignore demand constraints nor rely on credit booms. Can that be done? Yes. Will it be done? I doubt it.

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