David Cameron, the UK prime minister, states that “red warning lights are once again flashing on the dashboard of the global economy”. The lights are not as red as in 2008. Nevertheless, the difficulties caused by the fiscal austerity that his government recommends have become particularly evident in Japan and the eurozone. These stagnant high-income economies are the weakest links in the world economy. To understand why, one needs to analyse today’s most important economic illness: chronic demand deficiency syndrome.

Jack Lew, US Treasury secretary, provided a sobering overview in a speech delivered in Seattle, en route to last weekend’s summit of the group of 20 leading high-income economies in Australia. As he noted, the world is far from achieving the “strong, sustainable, and balanced” growth, promised at the 2009 summit in Pittsburgh.

Global recovery has been “uneven, with sharply different trajectories,” he said. “In the US, domestic demand surpassed pre-crisis levels in the first quarter of 2012 and is now about 6 per cent higher than before the crisis. Domestic demand in both Japan and the UK is about 2 per cent higher,” he added. “But demand in the eurozone has yet to recover the ground lost during the crisis, remaining more than 4 per cent below its pre-crisis level.”

What Mr Lew did not add is that this feeble performance – even the 6 per cent rise in real demand in the US over more than six years is pathetic by historical standards – occurred despite the most aggressive monetary policies in history. The official intervention rates of the US Federal Reserve, the European Central Bank and the Bank of England have been not far above zero since late 2008. The ECB struggled to raise rates above 1 per cent in 2011, but then succumbed to the pull of near zero. The Bank of Japan has been offering near zero rates for two decades.

Yet this has not been nearly enough. All these central banks have increased their balance sheets sharply. In the US and UK, the balance sheet expansion has stabilised. In the eurozone, the contraction since 2012 is being reversed, while the Bank of Japan’s balance sheet is heading towards the economic stratosphere, at 80 per cent of gross domestic product and counting.

How do we explain such weak demand, particularly in the eurozone and Japan? Only if we understand this do we have any hope of deciding on the right remedies. One can identify three sets of underlying explanations.
The first set stresses the post-crisis overhang of private debt and the damage to confidence caused by the sudden disintegration of the financial system. The by-now canonical response consists of cleaning up balance sheets and forced injection of capital into the banking system, supported by stress tests, to convince the public that the financial system is again creditworthy. To this should be added fiscal and monetary support for demand. In this view, a return to growth should be swift.

The second set of explanations denies this last proposition. It argues that the pre-crisis demand was unsustainable because it relied on huge accumulations of private and public debt – the former associated with bubbles in property prices. Japan suffered such a post-bubble reversal in private debt accumulation after 1990; the US, UK and Spain after 2008. The implication of this is that economies suffer not just from a post-crisis balance-sheet recession, but from an inability to generate credit-driven demand on the pre-crisis scale. Behind the unsustainability of pre-crisis demand lie global imbalances, shifts in income distribution and structurally weak investment. A symptom is a chronic financial surplus (excess of income over spending) in the private sector, as in Japan and the eurozone.

The third set of explanations points to a slowdown in potential growth, due to some combination of demographic changes, slowing rises in productivity and weak investment. But this last set of explanations feeds directly into the second. If growth of potential supply is expected to slow, consumption and investment will be weak. That will generate feeble growth in demand. If central banks fight this, they get bubbles. If they accept it, weak growth of supply turns into a self-fulfilling prophecy.

The high-income economies suffer from all three sets of ailments, to a greater or lesser extent: the US less, Japan and the eurozone more. Even China, albeit enjoying a much higher prospective rate of growth, also suffers from the second and third sets of concerns – even if it has not suffered a financial crisis. Its growth of recent years was driven by unsustainably rapid accumulations of debt and unsustainably high rates of investment, given the deceleration in its underlying growth.

The reason that extreme policy has been so ineffective is that the economies suffer from such deep-seated ailments. It is not just about weak supply. But it is also not just about weak demand. Nor is it just about the debt overhang or financial shocks. Each economy also has a different combination of ailments.

As a more demographically dynamic and more innovative economy, with low rates of private saving, the chances of escape into normal policy settings are better for the US than for the eurozone or Japan. Similarly, as an economy with catch-up potential, China ought to have a manageable adjustment. But the eurozone and Japan face far bigger challenges in restoring healthy growth. This is because their private sectors are unable to use the savings they wish to generate. This leaves them with unconventional policy choices, probably even more unconventional than those they have tried. The consequences of going further could be politically devastating, particularly in the eurozone. What those possibilities are and why they are so painful will be the topic of my next column.

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