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Recovery, Double-dip or Depression

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Abstract

Dark clouds have appeared on the horizon, just as confidence had increased among consumers and investors that the worst was over for the global economy. The clouds have gathered mostly for political reasons. The Europeans – the Germans in particular – have concluded that they cannot take the risk to persist with expansionary policies. They were discouraged to stay on course by their own history as well as by the nasty jolts delivered by the Mediterranean economies. It took some extraordinary jaw-boning by the United States President Barack Obama to convince German Chancellor Angela Merkel to come to the assistance of the almost bankrupt Greece. The American president saw his own set of problems emerge when a highly vocal and noisy part of his electorate began to question the wisdom of his approach to build a mountain of debt to revive an economy that has been stubbornly resisting recovery. These setbacks have made it difficult for the world's large economies to work together within one economic framework. At the G-20 meeting in Toronto, leaders failed to agree on a common path on which they will be prepared to travel. Asia is the only silver-lining on the horizon. This raises the question whether it has the weight and political will to guide the rest of the world.

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Introduction

In recent months, economic policy around the world has taken a turn for the worse and according to some economists, the global economy may be headed towards another recession. If that were to happen, the Great Recession of 2008-09 may turn into the Great Double-dip Recession of 2008-11. This may degenerate into a depression – the first since the late 1930s. The main reason for this unhappy turn of events is the policy-induced weakness in aggregate demand. This is more evident in Europe but may also happen in the United States (US).

Deep political divisions in the US have prevented the Obama administration from assisting the unemployed as their benefits run out. Republicans in the Senate, with some help from conservative Democrats, have blocked US$77 billion in aid to the unemployed proposed by the administration. The German government has pledged US$100 billion in tax increases and spending cuts even though the economy continued to operate well below capacity. The newly installed Cameron-Craig government in London has also opted for austerity. The French too are pulling back sharply.

Faltering Europe and America

For many analysts, what matters is not the fiscal tightening by the countries in Europe but very tight liquidity conditions, which will reduce overall demand along with levels of investment. Also of concern is the recent increase in the euro-dollar exchange rate. This means that the euro will no longer be headed in a direction that would produce sustainable buoyancy in its manufacturing sector. Given these developments in the European economies, those who count themselves among pessimists 'would argue that global demand growth will not be sufficiently strong to support a self-sustained recovery in the eurozone'.[2] This is indeed the case, the growing demand from China notwithstanding.

America is also uncertain about the direction it should take. Economic downturns – their depth and duration – are exceedingly hard to predict. This is especially the case when governments actively intervene to shorten their duration and reduce their depth. Sometimes the cures that are used may worsen the situation rather than reduce the impact of the downturn. The 2008-09 downturn – by far the most severe of the several that have hit the global economy over the last six decades – was supposed to have ended by the time the year 2009 was in its third quarter. The conventional measure – two successive quarters of growth – when applied to this recession seemed to suggest that the recession was over. Not so said Christina Romer, the chair of President Barack Obama's Council of Economic Advisors. According to her, she would be

[2] Wolfgang Munchau, 'Even eurozone optimists are not optimistic', *Financial Times (*12 July 2010), p.9.

prepared to say that the Great Recession had ended only when the rate of unemployment in the US declined to 5.5 per cent of the labour force. That, however, may not happen for many quarters. On the other hand, Larry Summers, the other important economic policymaker in the Obama White House, along with the US Treasury Secretary Timothy Geithner prefer the conventional interpretation. They believe that the aim of the policymakers should now be to manage the recovery and determine the time when the governments should begin the process of reducing the amount of stimulation used to prevent the economies from going through a free fall.

President Obama's challenge is to balance the three different types of advice he has been receiving from his White House advisers and experts.[3] The most vocal are those who watch politics, among them Rahm Emannuel, his chief of staff and David Axelrod, his senior advisor. Both are worried that given the sharp increase in the levels of public debt and associated fiscal deficits it would be politically costly – perhaps suicidal – to continue to stimulate the economy by using the printing press. Already, the 'tea party' movement has gained a great deal of political ground and threatens to deliver a major setback to the Democrats in the 2010 mid-term election. It has developed its campaign by suggesting that the mountain of debt the US has built up will have a severe impact on the future generations as they begin to pay off the accumulated debt through higher taxes and reduced consumption.

Summers and Geithner are the sources of the second line of advice to the president. They are not averse to continuing with some stimulation and providing compensation to the millions unemployed (both positions are unpopular with the Republicans), but also to focus attention on reforming the financial system through better regulation. According to them, the president needs to spend his political capital on bringing about structural changes in the economy so that the economy does not go through another spin as it did in 2008-09.

The third advice comes from people such as Romer who fear that by exiting more rapidly than the current situation warrants, the economy may head towards a double dip recession rather than continued recovery. This group has the support of some private economists with powerful credentials. The most prominent among these is Paul Krugman, a Nobel Prize winning Princeton professor and a columnist at *The New York Times.* 'Many economists, myself included, regard this turn to austerity as a huge mistake', he wrote in a recent article. 'It raises memories of 1937, when F.D.R's premature attempt to balance the budget helped plunge a recovering economy back into severe recession. And in Germany, a few scholars see parallels to the policies of

[3] For a detailed account of the debate on economic issues and policies in the Obama White House in 2009. See Jonathan Alter, *The Promise: President Obama, Year One* (New York, Simon & Schuster, 2010).

Heinrich Bruning, the chancellor from 1930 to 1932, whose devotion to financial orthodoxy ended up sealing the doom of the Weimar Republic.'[4]

Asia as a Locomotive

Perhaps the most troubling development is that the G-20 governments that recently met in Toronto failed to agree on a common framework for guiding the world economy back to full recovery. The history of the world economy shows that when national governments are left to work on their own, they are likely to work against each other rather than in support of one another. This happened in the period before the Second World War and produced the Great Depression. Does this mean that the world is headed not only towards a double-dip recession but perhaps a full-fledged depression? The answer is probably no because the large economies of Asia have not – at least not yet – joined the politically popular austerity drive in countries on both sides of the Atlantic. Asia may come to the world's rescue and in the process acquire greater economic heft.

While both the European Union and the US are projected to see growth of only one per cent in their respective gross domestic products (GDP) in 2010, the Asian countries are expected to do much better. Led by China, Asia is becoming the engine of global growth and may save the world economy from plunging into a double-dip recession. Asia's help is coming in many ways. Recent German data illustrates the deep structural changes that are taking place in the global economy would not have been possible without economic expansion in Asia. Since May 2009, when continental Europe was in the midst of the worst economic downturn in the post-war period, German exports have risen 28.8 per cent. Sales to non-European markets buoyed the trend; they increased by 39.5 per cent.[5] 'Without China, we would have hardly seen this recovery', said Hannes Hesse, managing director of the VDMA engineering associates. According to Deither Klingelnberg, a maker of machine tools, the demand from Asian and emerging markets is the main driving force for the ongoing recovery of the German manufacturing and exports. 'It's China, China, China by a long way, then India, Brazil, then Russia – and the US remains weak as do many of our European markets', he said.[6] While China may begin to slow down the unsustainably high rate of growth of recent months, it will remain close to 10 per cent.

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[4] Paul Krugman, 'That '30s feeling', *The New York Times* (18 June 2010), p.A25. Also see his interview with Bob Willis and Carol Massar of Bloomberg News,, 'Krugman calls for more stimulus', *China Daily (*8 July 2010), p.14.

[5] Gerrit Wiesmann, Daniel Schaefer and Ralph Atkins, 'China drives German recovery', *Financial Times* (9 July 2010), p.4.

[6] *Ibid*.

The Chinese are also engaged in reassessing their strategy. They will continue to let their economy grow only if its suits their economic, political and social needs, not to become the locomotive for the rest of the world. According to Geoff Dyer of the *Financial Times*, one of the more perceptive students of the Chinese economy, 'the Chinese economy is going through two delicate transitions. Worried about over-heating, Beijing has applied the brakes in the two sectors that have helped propel the recovery from the financial crisis last year, ordering a clampdown on property speculation and limiting lending to local government infrastructure projects. At the same time, it is trying to find a new growth model that relies less on the 20 per cent increases on exports that it enjoyed for most of the past decade.'[7]

Some other large Asian economies may step forward. For instance, there is a lot of life in Indonesia which could begin to spend more by relying not just on taxes but also on borrowing. Emerging Asia as whole, with a quarter of the world's gross domestic product, has less than 8.0 per cent of its outstanding bonds. Increasing the ratio will help not only to increase domestic demand, it could also put a floor under which the global economy would not fall. India, South Asia's anchor economy, has also recovered well from the mild slowdown it suffered when the world went into the Great Recession of 2008-09. While its policymakers hope for a rate of growth of 10.0 per cent a year beginning 2010-11, an increase of 8.0 to 9.0 per cent appears to be feasible. Bangladesh, once South Asia's poorest performer, is now moving ahead at a respectable rate of growth of 6.0 percent a year. It is only Pakistan that remains economically stagnant. Its GDP is expected to increase by 4.0 per cent in 2010-11. The reason for its poor performance has to do more with non-economic factors such as persistent acts of domestic terrorism than with changes in its economic environment.

Asia then has become the economic area that will begin to carry a great deal of water for the global economy. But for that to happen, the West must not totally turn away from expansion and move towards austerity. To use another metaphor, Asia is developing broad shoulders but they can carry only so much burden for the moment.

Conclusion

It appears at the time of this writing (July 2010) that the recovery from the Great Recession of 2008-09 may not be as smooth and easy as it was first expected. The various stimulus packages financed by several large countries stopped the recession from becoming more severe. The question now is the form and speed with which the governments should exit from adopting stimulation as the most important economic policy of the day. Also, the way the recovery is

[7] Geoff Dyer, 'All eyes on Bejing to drive world growth', *Financial Times* (12 July, 2010), p.4.

taking place is giving more weight to the large Asian economies, bringing forward the day at which their presence in the global economy will become even more pronounced.

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