

New Economic World Order: Perspectives from the U.S.

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Flims
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Where are we?

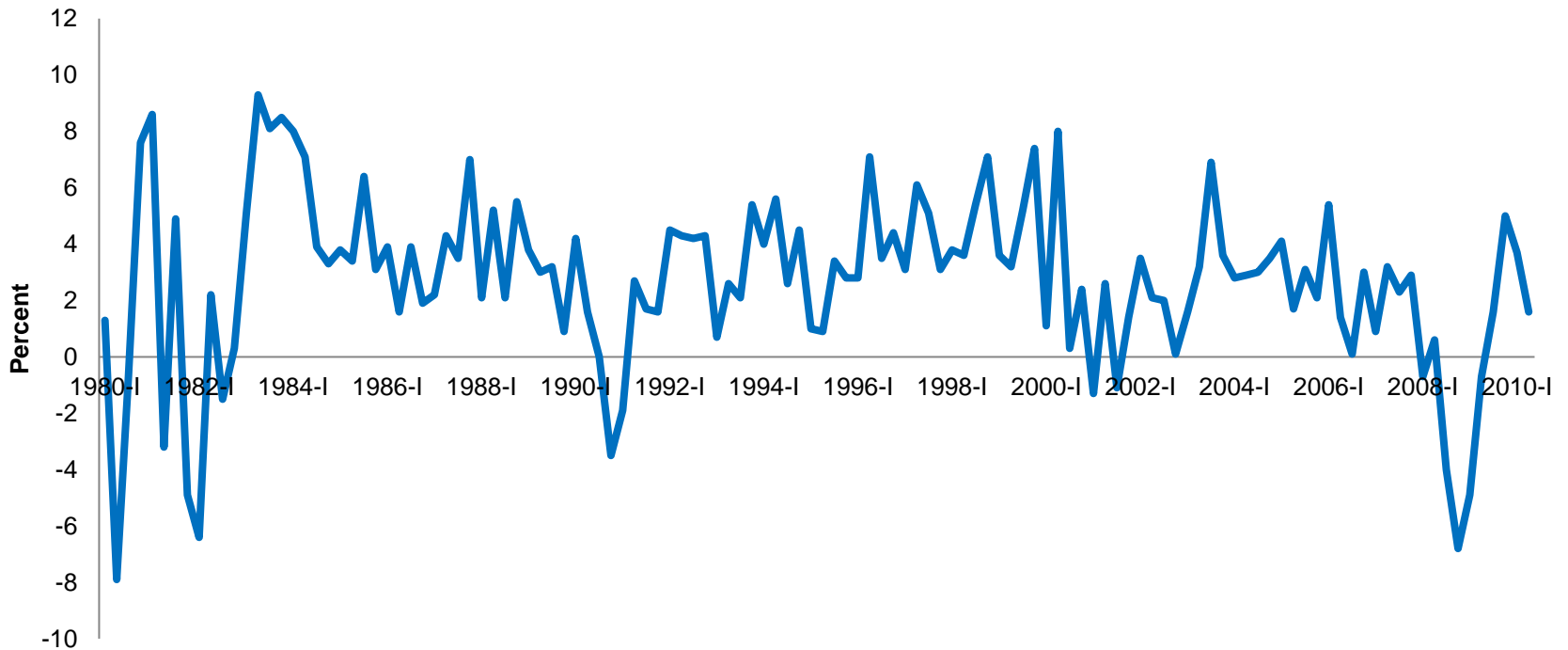
- Pulled back from the brink on which we seemed to be poised two years ago
- But economy is still weak
- With growth likely to slow in second half of 2010 and 2011
 - Even in optimistic forecasts, too slow to reduce unemployment significantly

Where are we?

Percent Change From Preceding Period in Real Gross Domestic Product

Seasonally adjusted at annual rates

Source: Bureau of Economic Analysis Table 1.1.1



Labor market

- Official unemployment stuck around 9.5%
- Broader measure worse—one out of six Americans who would like full time job can't get one
- For first time, almost half of unemployed are long-term
 - Labor market flexibility by itself is not sufficient to ensure well performing economy
 - Weak labor market part of negative cycle—contributing to weak aggregate demand

Other continuing weaknesses

- Foreclosures continuing apace
 - Administration programs ineffective
 - One out of four mortgages underwater
 - 1.65 million foreclosures in first half of 2010—faster pace than 2009
- Analogous problems in commercial real estate

Other continuing weaknesses

- Contributing to problems in banking
 - 140 bankruptcies in 2009
 - Even more are likely in 2010
 - 119 already as of September
 - Many other banks in trouble
 - Increasing number of FDIC “Problem List”
 - 829 on list in second quarter 2010, up from 702 at end of 2009
 - Large bank profits associated with trading, not lending

Other continuing weaknesses

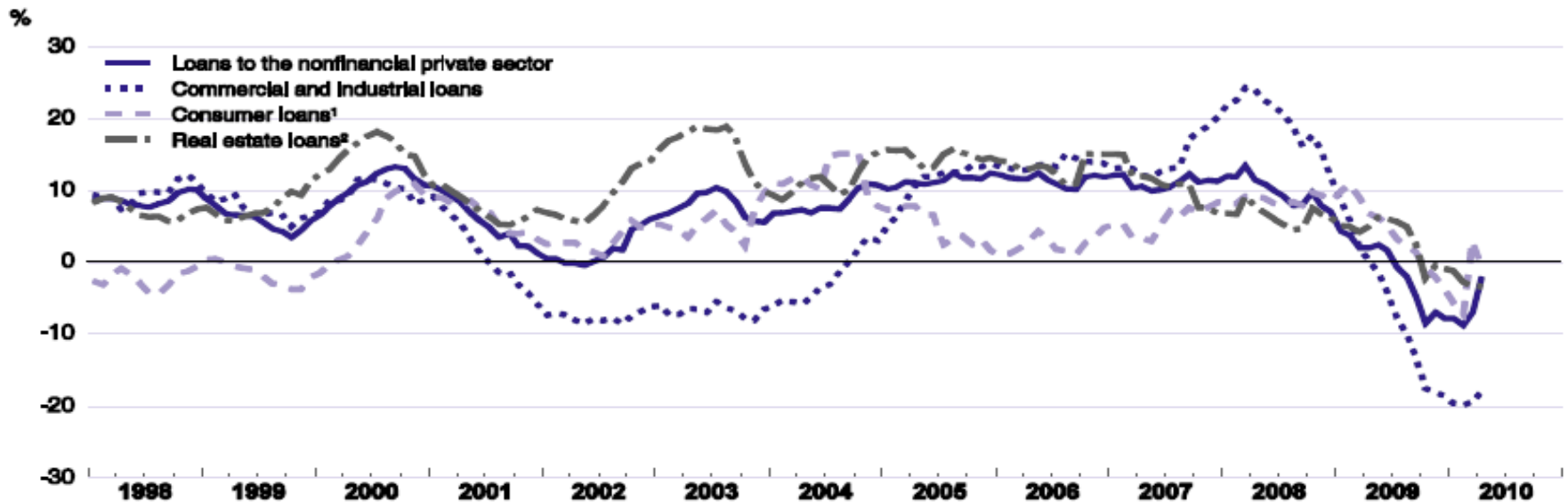
- Lack of access to credit, especially for SME's
 - Even though banks have access to low cost capital, interest rates they charge high
 - Value of collateral reduced markedly
 - Bank credit remains weak: annual growth rate in 2010Q1: -7.6% and 2010Q2: -5.9%

Other continuing weaknesses

Figure 1.3. Bank lending remains weak

Year-on-year growth rate

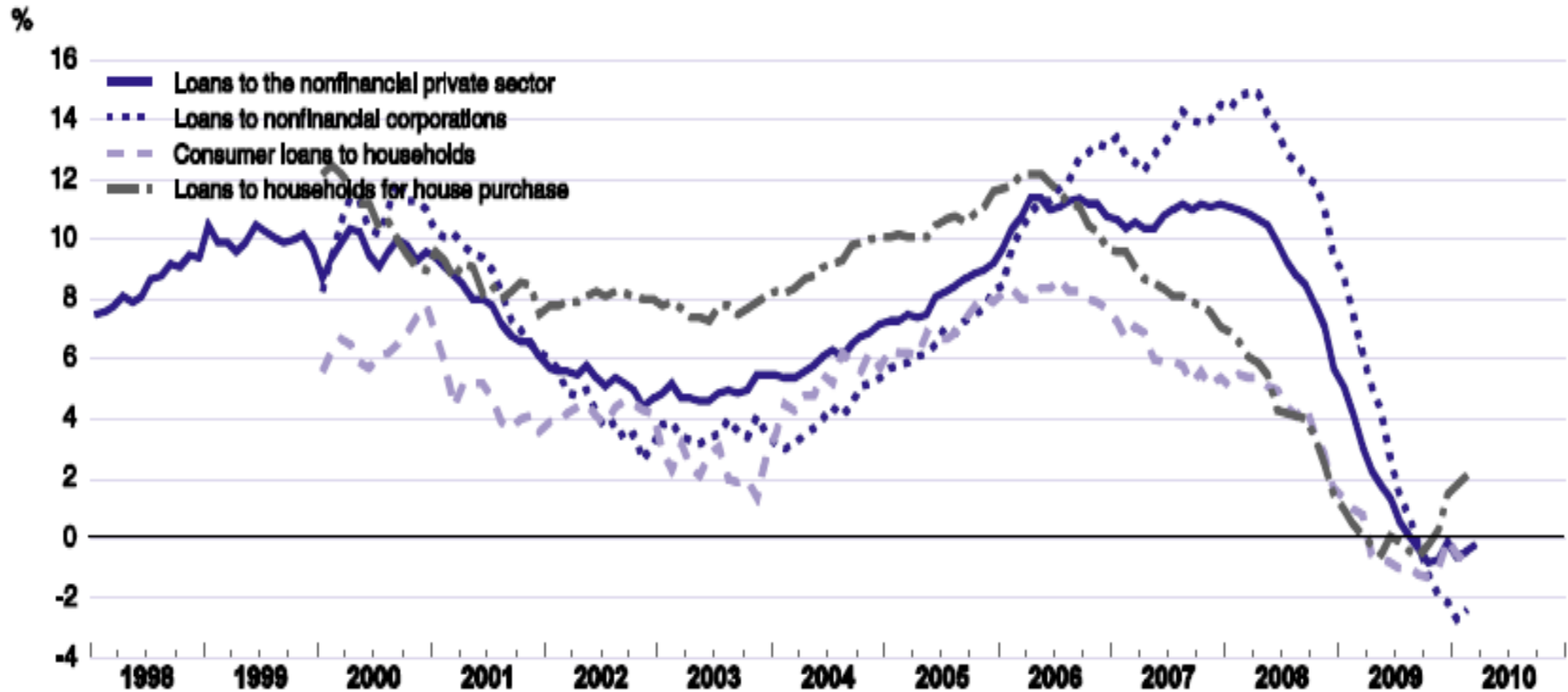
United States



Source: OECD Economic Outlook No. 87, May 2010.

Other continuing weaknesses

Euro area



Source: OECD Economic Outlook No. 87, May 2010

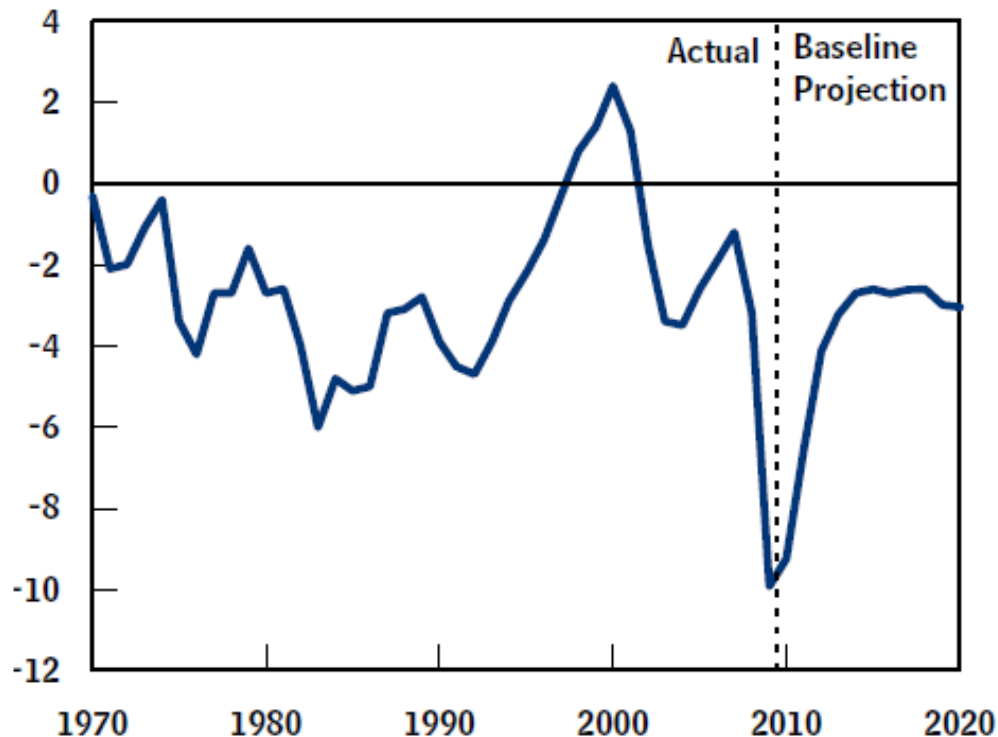
Other continuing weaknesses

- State and local government (accounting for a third of all government expenditure) facing major shortfalls
 - Balanced budget framework means that have to cut back spending
- End of stimulus
 - Little appetite for another stimulus
 - Political conflict over form of stimulus may result in now stimulus or a poorly designed one

Other continuing weaknesses

The Total Deficit or Surplus, 1970 to 2020

(Percentage of gross domestic product)



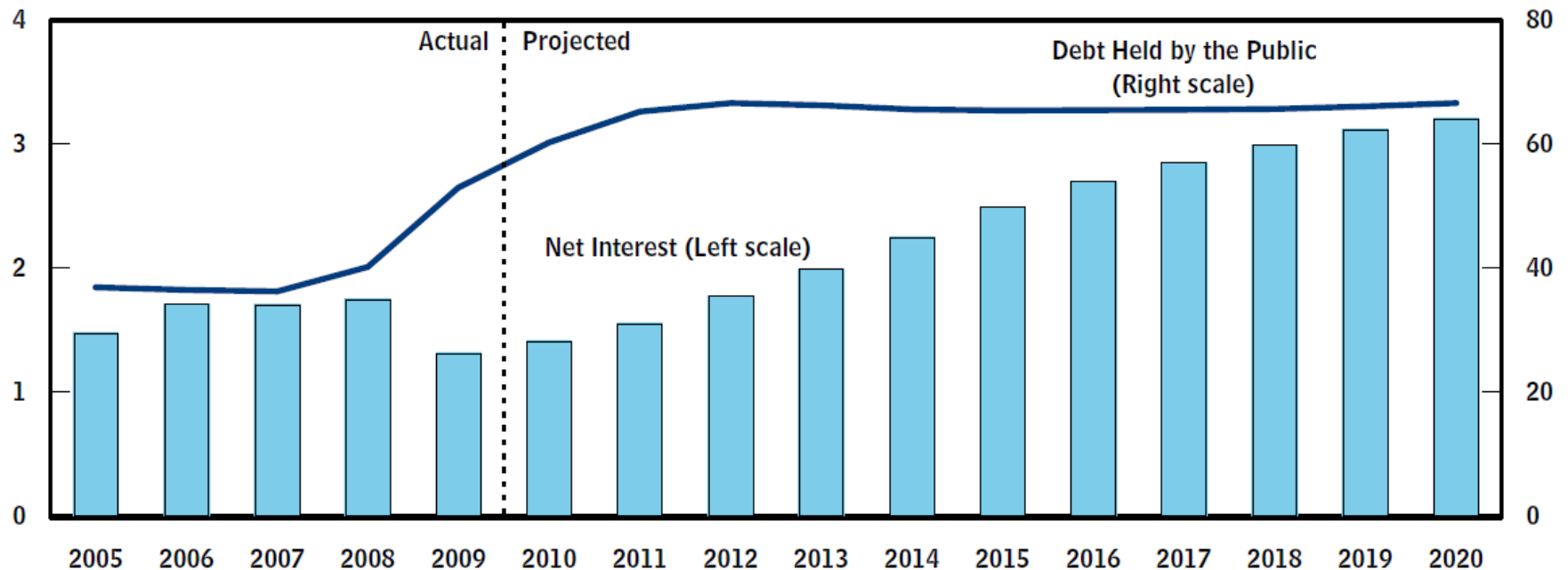
Source: Congressional Budget Office.

Other continuing weaknesses

Debt Held by the Public and Net Interest

(Percentage of gross domestic product)

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Biggest risks going forward

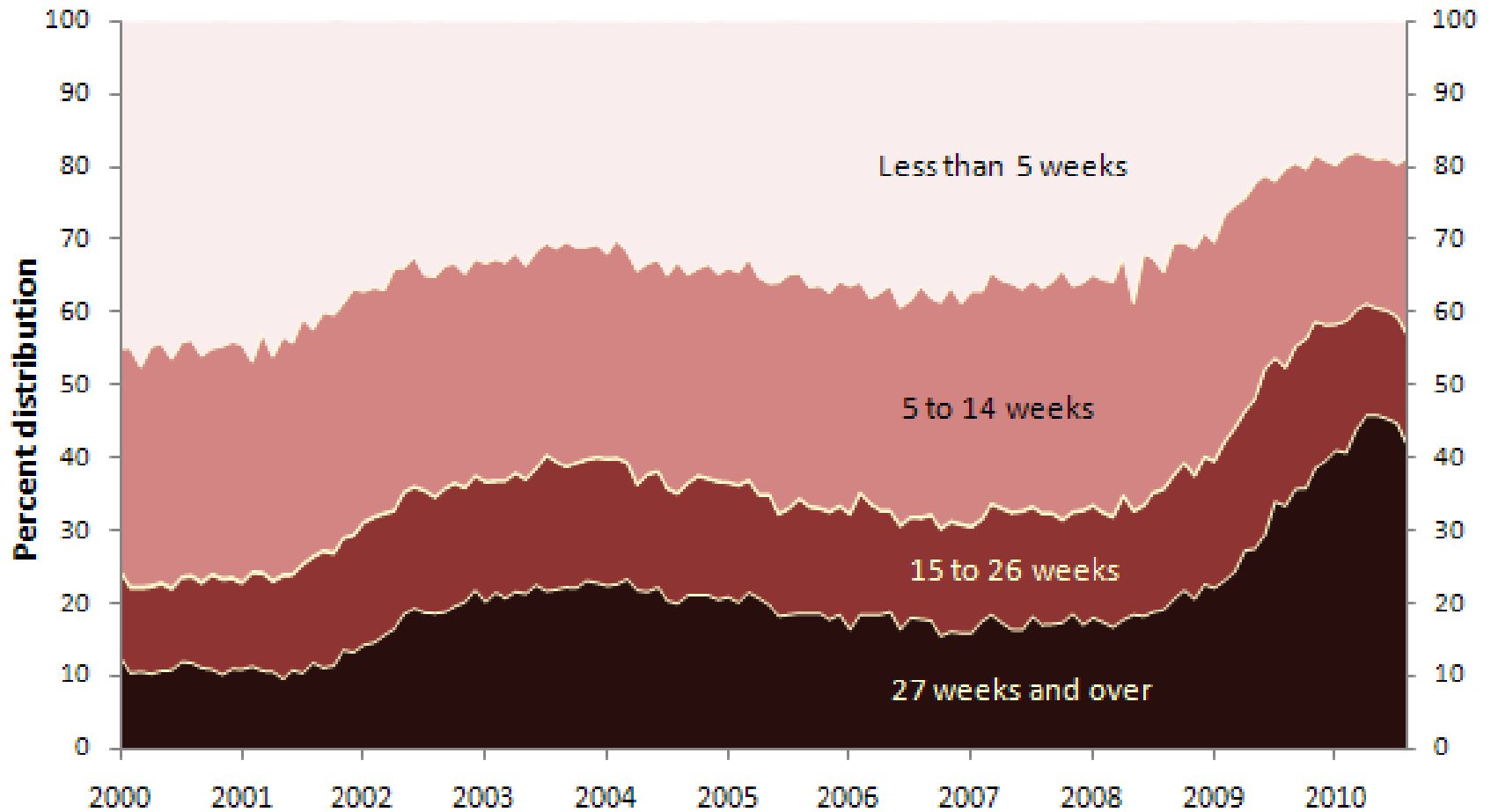
- Biggest problem: lack of adequate aggregate demand
 - What sustained economy before crisis was bubble
 - Savings rate fell to zero
 - Unsustainable
 - What will fill the gap?
 - Government assistance temporary palliative

The challenge of reducing unemployment

- With labor force growth of 1% and “normal” productivity growth of 2 to 3%, growth is too small to provide jobs for new entrants—unless economy grows 3 to 4%.
- As weak economy continues, individuals lose skills, loss of human capital
- Risk of a “new normal” with high sustained unemployment (hysteresis effect)
- Problems in housing market exacerbate this fundamental problem
 - “Flexibility”—ability to move around country—had been one of strengths of American labor market
 - With low or negative equity mobility reduced

The challenge of reducing unemployment

Duration of unemployment, percent distribution, January 2000–August 2010



Source: U.S. Bureau of Labor Statistics

An export led recovery?

- Some increase in exports recently
- But too small to be the basis of recovery
- And stronger dollar and a weaker Europe may make continued growth less likely
 - Europe's economy is especially likely to be weak if many countries adopt austerity packages
 - Long history of “Hooverite policies”—they almost never work, few apparent exceptions growth not because of austerity, but related to expansion of exports
 - Whole world can't export their way out of crisis
- China's exchange rate not key problem
 - Even if it appreciates, it will not have major impact on US multilateral trade deficit

Exchange rate volatility

- But the world is likely to be marked by high exchange rate volatility
 - Uncertainty bad for investment
 - Exchange rates like negative beauty contests
 - Right now the focus is on Europe's fiscal problems
 - But attention is likely to shift at some time to US problems
 - Fiscal deficit
 - Hidden pension deficits in states
 - Political gridlock
 - Other economic problems

Risk of protectionism

- As scope for fiscal policy narrows, monetary policy proves ineffective, and economy remains weak, likelihood of growing protectionist sentiment
 - Exacerbated by successes in Asia
 - Already evident in measures against China and India

Risks of monetary policy?

- Some worry that continuing low interest rates, quantitative easing will lead to inflation
 - Unlikely, given excess capacity
 - Real challenge: *if and when economy recovers, can Fed drain excess liquidity from economy in such a way as to prevent another downturn and an onset of inflation?*
 - Fed's record should not give us much confidence in their ability to manage
- Longer term risk of quantitative easing: large capital losses for government

Risks of political gridlock?

- Democrats want infrastructure, extended unemployment coverage, programs for small businesses, extension of middle class tax cuts
- Republicans want extension of tax cuts for upper 2%
 - Country can't afford, and couldn't afford when they were enacted
 - Evidence is that they would stimulate the economy very little

The structural challenge

- Several important sectors need big adjustments
 - Housing, real estate—overbuilt in many parts of country
 - Finance—needs to be downsized (help finance real estate, credit card practices being circumscribed)
 - Health care—reforms unlikely to affect soaring costs
 - Manufacturing—successes in productivity growth, changing comparative advantages mean that employment will likely decrease

The structural challenge

- Source of strength—education, hi-tech—
not big enough to compensate for
weaknesses elsewhere
 - Universities facing financing problems
 - Visa restrictions
 - Financial crisis has hurt venture capital firms

The medium to longer term prognosis

- U.S. mired in Japanese-style malaise
 - Perhaps with slightly higher growth (higher labor force growth)
 - But greater inequality, weaker social protection
 - Most Americans have seen a decade of declining real incomes
 - Exacerbated by difficulty in coming to terms with its standing in the New Global Order
 - High growth in Asia
 - Extension of Asia's influence in rest of world
 - Weakening of “soft power”
 - Questioning of relevance of “hard power”

A new global economic order

- No longer dominated by one “superpower”
 - Though China’s income per capita will remain much below that of the U.S.
- New thinking about alternative political and economic models
 - Crisis raised questions about long standing views of economics
 - Conflict of ideas will be particularly strong in developing world
- Greater difficulty in reaching global agreements
 - Evident in Copenhagen