



The path of true recovery never did run smooth

If serious policy errors – such as the macro policy tightening and financial system neglect that caused Japan’s lost decade in the 1990s and the premature tightening that caused the 1937–38 reversal of the US’s recovery from the Great Depression – can be avoided, the major economies should stay on their recovery path over the coming years. Yet, while remaining on an average up-trend, that path is likely to prove bumpy.

The handoff of the growth baton from the public sector back to the private sector is rarely well synchronised. Thankfully, we are only rarely confronted with the need for such explicit transitions. As a result, however, there is no practiced coordination. Weaning economies off discretionary fiscal policy and quantitative easing will have unpredictable side effects. So we are likely to see both overshooting and undershooting of demand versus potential from various sources over the coming years, at different points in the upswing.

There is reason to think that, in most advanced economies, the crisis has driven down potential output growth – the sustainable trend rate of productivity and labour force growth. The human and capital investment forgone, the disruption of credit markets and hence the likely misallocation of financing, and the reallocation of labour and capital across sectors (say, from finance and construction to export industries) will require adjustment, and that will take time. As long as growth does not vastly overshoot or undershoot potential on a sustained basis, the economy will adjust, but the process will not be smooth.

The banking systems in most major economies retain a lot of bad assets on their books and are still rebuilding capital and liquidity. This is set to be a drag on growth over the near term, but that is not the aspect that will lead to bumps in the road. The steps taken by policy-makers to stabilise the banking system have prevented outright panic. Yet

some of the underlying problems remain, and it is questionable whether economies can grow out of those problems without further incident. In some countries, we could still have a recurrence of overt financial fragility a year or two down the road. At the very least, the threat may arise.

Internationally, there is a limit to how many countries can be net exporters at once. The US and a number of other trade deficit economies are raising their savings rates and their currencies are declining. Their governments are also giving policy signals (of varying credibility) that they expect the world to allow for adjustment to greater domestic demand in – and thus exports from – these economies. In the short term, Asian net imports have picked up, even though some other surplus countries in Europe and the Middle East have continued to rely on external demand. Yet these surplus economies’ governments have also said they do not want a sustained decline in their net exports. Something has to give. While such an adjustment will occur through a combination of give and take, exchange rate and real sectoral changes, it is likely to be accompanied by bursts of trade friction and currency volatility. That’s another reason the global recovery will not be smooth.

The world economy is in much better shape than it was a year ago. Macro-economic policy stimulus has prevented the worst outcomes, and financial panic has receded. The trick will be to sustain that positive overall environment while major adjustments take place within and between economies: from public spending to private demand; from extraordinary policy measures to normal automatic stabilisers and interest rate setting; from booms to lower sustainable growth rates; from construction and financial services to new sources of employment and growth; from guaranteed banks to boring banking; and from net exporters to net importers (and vice versa). And that represents quite a challenge for policy-makers.

Carl Astorri
+ 44 20 7753 1612

Jean-Maurice Ladure
+ 44 20 7753 1469

Henry Lancaster
+ 44 20 7957 2426

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