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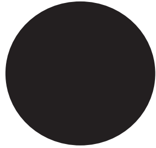

# A Goldilocks World Economy?

*Sherle R. Schwenninger*

Over the past decade and half, two developments in the world economy have come together to create the conditions for what could be a new era of faster economic growth and rising prosperity. One development involves the integration of China, India, and the former Soviet Union into the global economy. The inclusion of these three populous regions into the global economy has created what economists call positive supply-side shocks, resulting in surpluses in labor, capital, and productive capacity. The most obvious impact of China, India, and the former Soviet Union has been on the world's labor market. Their entry into the world economy has, in effect, doubled the global labor force in the course of a decade, raising the return on capital and dampening wages and inflation. Capital has also become plentiful because of the high-saving propensities of China and other Asian economies. In fact, Asia is producing more savings than the world can absorb. This glut of world savings, together with the increasing globalization of financial markets, has predictably driven down the cost of capital and has helped keep interest rates low worldwide.

The other development relates to the technological advancements and other changes associated with the new economy, which have substantially increased U.S. and world productivity growth. American productivity growth has risen to the pre-1973 levels that were responsible for the rapid improvements in American living standards, jumping from an average of 1.53 percent for the period 1973–95 to 2.6 percent in the period from 1996 to 2005. World productivity has shown a similarly impressive increase. This productivity acceleration is the product of three over-lapping revolutions: a technological revolution in data processing and communications; a related revolution in the production and distribution model made possible by globalization and these new technologies; and an efficiency revolution in materials and energy.

Together, the productivity-enhancing revolutions associated with the new economy and the positive supply-side shocks brought about by the integration of China, India, and the former Soviet Union into the world economy have created a new abundance. This new economy contrasts sharply with the supply-side constrained economy of the 1973–95 period, which diminished economic growth expectations and radically altered the prevailing policy framework, ushering in an era of supply-side policy measures aimed at taming inflation and deregulating markets. By contrast, the new abundant economy has created the conditions for more rapid economic growth and rising living standards without greater price and wage inflation, making possible once again a full-employment economy that delivers great prosperity to the overwhelming majority of Americans.

But, as we have seen with the tech bubble of the late 1990s and with growing income and wealth inequality, the new abundant economy can bring with it a new set of challenges, for which many of the supply-side policies of the 1980s and 1990s are in-

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appropriate. In a world of rapidly rising productivity growth and excess labor and capital, asset bubbles and deflation, for example, are greater worries than inflation; thus maintaining demand and wage income must become more important policy objectives than stimulating supply. If not properly managed, the problems of asset bubbles and inadequate demand can be as serious as those from which the U.S. and world economies suffered from the mid-1970s to the mid-1990s. In fact, the U.S. and world economies have underperformed their potential over the past decade, in large part because governments have failed to understand these problems.

*New Policy Challenges*

In spite of the very favorable growth conditions for the U.S. and world economies, U.S. economic growth has lagged behind the performance of the economy in the 1950s and 1960s, and has been only roughly on par with the oil shock years of the 1970s. From 1995 to 2004, a period associated with the first decade of the new economy, U.S. gross domestic product growth averaged 3.24 percent in comparison to 4.12 percent in the 1950s, 4.44 percent in the 1960s, and 3.27 percent in the 1970s.[1] World economic growth, including per capita economic growth, was also better in the 1950s and 1960s, and somewhat better in the 1970s than it has been over the last decade, notwithstanding impressive growth in the last three years.

As worrying, the benefits of economic growth have been highly concentrated and uneven. In the United States, the majority of the gains from improving productivity growth have gone to a small group of professionals and managers, and to capital owners. For example, in 2004, even excluding capital gains, the real income of the richest 1 percent surged by almost 12.5 percent.[2] Yet real median family income, including the real earnings of the typical college graduate, actually fell. World economic growth, likewise, has been highly concentrated in a few fast-growing economies, such as China.

The explanation for the economy's relatively poor growth performance lies, in part, in a flawed conceptual framework for policy. Indeed, the greatest obstacle to realizing the full potential of the new abundant economy may be a way of thinking more appropriate to the supply-constrained 1970s and 1980s, which has led us to believe that pushing the economy closer to full employment to boost wages would lead to more inflation or that more public investment without reducing the budget deficit would raise interest rates. In fact, it is only because economic policy has, at times, deviated from this conventional wisdom that the economy has done as well as it has, especially after the bursting of the tech bubble in 2001, when the Federal Reserve slashed interest rates and federal deficit spending increased significantly.

*The Problem of Asset Bubbles*

Let's begin with the question of inflation. In an economy with an abundant supply of labor, savings, and productive capacity, the main macroeconomic problem is not wage or goods-price inflation. It is the tendency of the economy to be prone to asset inflation, which can quickly turn into asset bubbles, especially when low inflation is accompanied by new technological advancements that spark "irrational exuberance" and excessive credit creation. Asset bubbles can raise economic growth for a short period of time when they are inflating, as they did in the late 1990s, but they can undermine growth on the way down, as they did in 2001 and 2002, and they can act as a prolonged drag on the economic growth as the economy works off the excesses of investment and consumption that accompany asset bubbles.

Thus, while wage and price inflation was the main problem of the supply-and innovation-constrained 1970s and 1980s, asset inflation and asset bubbles have been the main macroeconomic challenges in the new abundant economy, just like they were in

the [new abundant] [CUT?] economy of the 1920s. In fact, as history and theory would have predicted, the new abundant economy has produced successive asset-price bubbles or at least asset-price inflation. First, there was the telecom and tech bubble of 1997–2001, the scale of which was reflected in the fall of the NASDAQ from a peak of 5,048 in March 2000 to 1,114 in October 2002. The tech bubble has been followed by the housing and real estate bubble, which has now begun to deflate. Housing prices rose more than 60 percent over the last five years and by an even greater amount in certain hot markets on the coasts.[3] There is also some evidence of an asset bubble in commodities like gold, copper, and oil, which have shown signs of speculative froth and excessive price run-ups.

Asset-price bubbles pose problems for both the real economy and for macroeconomic policy. First, they distort investment away from more productive ends. Over $3 trillion in wealth was lost when the NASDAQ bubble burst, a significant portion of which was mis-invested in telecom-related capacity that is now becoming obsolete because of more recent technological advances. Likewise, the housing bubble has resulted in the mis-investment of a similarly large sum of wealth, as reflected by the growing excess inventory of unsold four- and five-bedroom homes in many locations.

Second, asset bubbles skew wealth inequalities because they dramatically increase the wealth of asset owners—at least for a time. This, in turn, can drive down the savings rate because of the strong wealth effect that rising asset prices have on savings in the United States. As people feel richer because of rising equity or housing prices, they tend to increase their consumption. This is especially true of individuals in the top quintile of income and wealth in the United States. For example, a study by Ajay Kapur, chief global strategist for [Citibank,] [CITIGROUP?] found that the falloff in the national savings rate from 1996 to 2001 was due to a decline in the savings rate of the top 20 percent, which he attributed in large part to the wealth effect from rising asset prices.[4] A similar process accounts for the decline in savings in 2004–05.

Finally, and most importantly, the bursting of asset bubbles can lead to financial crises, demand shocks (deflation), and/or investment stalls (i.e., long periods of weak investment). As noted earlier, asset bubbles may for a short time lead to higher growth, but the downturns that follow portend either a sharp economic collapse or a prolonged slowdown as demand weakens and investment stalls. The 1929 stock market crash led to what economists call bad deflation and a full-scale depression. The bursting of Japan's asset bubble in the early 1990s caused a prolonged 15-year slowdown in spite of an unprecedented monetary easing. The U.S. economy was able to avoid deflation after the NASDAQ bubble burst only through dramatic rate cuts and increased federal spending, but even then the recovery was the weakest recorded in the postwar period, and it came at the price of a new asset bubble in housing and commodities.

In fact, the dilemma policymakers face in responding to a deflating bubble with asymmetrically easier monetary policies, as the Fed did in 2002, is that it can set the stage for a new set of imbalances, in this case a housing bubble. Worse, the deflation of the housing bubble could lead to slower economic growth, if not an outright recession. Avoiding asset bubbles, especially follow-on bubbles, would require a different kind of macroeconomic policy than has prevailed over the past decade. A less easy monetary policy combined with a more expansionary fiscal policy with more spending on public investment might moderate asset inflation while promoting stronger growth. It would also require more adroit use of regulatory measures to constrain excessive credit, such as higher margin requirements during moments of stock market exuberance, or new public spending programs to channel

excess global savings into needed public investment.

*Inadequate and Uneven World Demand*

A second reason for the relative poor performance of the new abundant economy is inadequate and uneven world demand, which is often the characteristic of economies with rapid productivity growth and excess labor. New business investment in many sectors of the economy is stalled today not because the cost of capital is too high or the budget deficit is crowding out private investment, but because many companies do not see major new growth and profit prospects due to relatively weak demand. Many firms are sitting on large cash reserves and are using the cash to buy back stock rather than expand operations. This may be good for the shareholders in the short term, but it is not good for economic growth and job creation.

Policymakers seem to have forgotten that an economy with excess labor and rapid productivity growth tends toward underconsumption, resulting in weak demand and slower growth. Rapid productivity growth has the paradoxical effect of displacing labor and raising unemployment, weakening the bargaining power of labor and decreasing wages. Countervailing government policies are needed to ensure that the benefits of productivity gains are widely shared and that aggregate demand is maintained. But policies such as real increases in the minimum wage or generous retraining programs, or new international public spending programs to promote more consumption abroad, have not been an acceptable part of the new economy's policy framework. Demand in the United States has been maintained therefore not by wage increases but by a combination of rising consumer debt and by extracting equity out of rising housing values. But such a strategy for maintaining demand is not sustainable, especially with housing prices beginning to soften and even fall in many locations.

The paradox of productivity problem is exacerbated in a world economy increasingly dominated by high-savings, production-oriented economies, like many of the Asian economies. These economies tend to underconsume and overproduce, and thus they depend on export demand to drive their economic growth. The overall result is not only inadequate and uneven worldwide demand but an unhealthy dependence on the U.S. consumer market, which is reflected in rising current account imbalances. In 2005, 32 percent of China's and 23 percent of Japan's merchandise exports went to the United States. This year, China and Japan are running current account surpluses of 7.2 percent of GDP and 3.6 percent of GDP respectively, while the U.S. current account deficit tops {6.4} {CHECK. GRAPH SAYS 6.7} percent of GDP. Adding to these imbalances are the current account surpluses of the major oil-exporting economies, which are nearly as large as those of Japan and China.

Weak world demand outside the United States has pushed more imports into the United States and reduced the market for American-made goods and services. Thus, it is not surprising that the U.S. current account deficit has increased from 3 percent in the late 1990s to more than 6 percent today as the weight of the high-savings Asian economies in the world economy has increased. The trade deficit, in turn, has acted as a drag on U.S. economic growth and has created an unsustainable pattern of weak economic growth that is too dependent on debt-led U.S. consumption. Weak demand has also contributed to a weak economic growth environment in another way. With too much supply chasing too little demand, firms in many sectors of the global economy have no choice but to engage in cutthroat measures. Companies are thus trying to increase profitability, not by tapping expanding world markets but by cutting costs, especially wage costs, which further reduces global aggregate demand.

For this reason, the current focus of top

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policymakers in both parties on cutting the budget deficit and raising U.S. savings in order to lower interest rates is counterproductive when the real problem is weak world demand. The driving forces behind weak world demand and the global imbalances are Asia's structural savings surplus, with China playing an increasingly significant role, together with the large current account surpluses of some of the main oil-exporting economies. An analysis of the global savings picture—with the stock of global savings rising more rapidly than consumption—suggests that American savings are low because Asia's are abnormally high. The fundamental economic fact, then, is that the United States cannot safely reduce its excess spending if others do not decrease their excess saving at the same time.

*A Suboptimal Pattern of Growth*

In large part because of the failure of policy to respond properly to the problems associated with the new abundant economy, the U.S. and world economies have grown in a suboptimal way for the past decade. From 1995 to 2001, the world economy was too dependent on an investment boom in the emerging markets in Asia and then by the tech bubble in the United States and Europe. Since the bursting of the tech bubble in 2001, the global economy has been driven by the twin engines of consumption and housing in the United States and corporate and state-directed investment in China. These two engines have, respectively, stimulated economic growth in the capital-goods exporting economies of Germany and Japan and the oil-exporting and mineral-rich economies of the world economy.

The Asian and European export economies and the oil-exporting surplus countries of Russia and the Persian Gulf have recycled their capital surpluses to support consumption in the United States and to fuel a housing and real estate boom in the United States, Britain, Australia, and parts of Europe. This housing boom—in many places, a housing bubble—has been one of the main engines of world economic growth because it has also helped fuel consumption. Over the past five years, for example, consumption and housing have accounted for 90 percent of U.S. GDP.[5] While personal consumption and housing have been hot, capital investment in the United States and throughout much of the industrialized world, outside of China, has been relatively weak because companies have been reluctant to invest until the overcapacity of the late 1990s has been worked off and until they have seen new growth opportunities, which have been slow to materialize in today's demand-constrained world economy.

This pattern of economic growth has produced more growth than some economists thought possible given the excesses of the late 1990s and the problems associated with international terrorism. But, still, it has not been optimal because it has been too dependent on American consumption, which in turn has been too dependent on debt-led financing and a housing boom. In the United States, there is evidence that this pattern of consumption is beginning to reach its limits. With their real wages stagnant or falling, millions of Americans have resorted to borrowing in an effort to maintain their living standards. Last year, household debt rose to 131 percent of disposable income,[6] partly because many Americans have pushed their credit card debt to the limit and because many, including many high-income Americans, have piled on mortgage debt. As a result, debt payments now consume 18.7 percent of the income of the average American family, and an ever higher percentage among those in the bottom two-fifths of the income ladder.[7]

A slowdown in the U.S. consumer economy would have a serious negative impact on China and other Asian export-oriented economies given their dependence on the U.S. consumer market and the fact that they are already burdened with overcapacity in many manufacturing sectors. Thus, a sput-

tering U.S. consumer engine could easily create problems for the other main engine of recent world economic growth. A slowdown or even a recession caused by the collapse of the interrelated consumption and housing boom in the United States would not be the hard landing that some deficit hawks are most concerned about. But it would raise some difficult policy questions in light of the prolonged effects of deflated asset bubbles on economic growth and the important role U.S. consumption has played in driving a world economy in which high-savings, production-oriented economies make up a growing percentage of the world's GDP.

*A More Optimal Growth Path*

A slowdown in U.S. consumption as a result of a correction in the housing market creates some dilemmas for policymakers who seem to have a limited understanding of macroeconomic policy in an abundant economy. On the one hand, cutting the budget deficit without other off-setting measures, as both parties are now proposing, would only push the economy closer to an all-out post-bubble recession, which by its nature could be prolonged. On the other, responding to a deflating housing bubble with {asymmetrical easier monetary policy} {AWK. EXPLAIN.} may only create another bubble, further delaying the transition to a more optimal pattern of economic growth.

A more optimal economic growth path would entail an interrelated two-track strategy of increasing public spending on productive investment in the United States and expanding consumption demand abroad, especially in the large, emerging market economies where productivity growth is improving rapidly. More specifically, the first step out of the bubble cycle without falling into its weak demand and slow growth trap is not for the United States to cut its budget deficit, but to increase public investment while the surplus Asian economies and oil-producing economies increase consumption. In the short term, this combination would help sustain global economic growth while putting it on a more optimal long-term course. Increased public investment in the United States would lead to increased private investment and greater productive capacity, enabling American-based companies to take advantage of rising export demand for their goods and services. It would also lead to rising wages, enabling households to reduce their debt burdens without cutting back on consumption. A combination of increased investment and rising wages at home with consumption-led economic growth abroad would create the true Goldilocks economy.

*A Public Investment Strategy*

Increased public investment in the United States must be one of the pillars of any transition out of the current bubble economy. Public investment is the most effective way to increase both demand and investment at the same time. If, in spite of low interest rates or low inflation, companies will not commit to more investment spending because of weak demand or uncertainty, then the best way to jump-start more investment is to do so directly by increasing public investment outlays. Such investment would also have the advantage of creating more jobs, particularly more good jobs, putting upward pressure on wages. Combined with efforts to promote greater consumption and demand abroad, a public-investment-led strategy would correct the imbalances created by successive asset bubbles and simultaneously strengthen America's productive economy.

A public-investment-led transition strategy would have advantages over other policy alternatives. First, in terms of demand, most of the public investment would go to stimulate domestic investment and jobs, and thus would be more efficient than either supply-side or demand-side tax cuts in countering an economic slowdown. Second, in terms of investment, public investment—particularly public infrastructure in-

vestment—is a more direct and more reliable way to increase both public and private investment than are supply-side tax cuts or deficit reduction, the policy choices respectively of the Bush administration and former Clinton administration officials. More public investment is needed to correct the current shortcomings in both the nation's physical infrastructure and knowledge capital. Any increase in public investment related to these unmet needs would have positive returns for the economy and would, in any case, be better than no increase in public investment at all.

Public investment would also be a more efficient way to stimulate private investment. Supply-side tax cuts are particularly inefficient in that the money saved from reduced taxes is just as likely to be consumed or invested abroad. As for deficit reduction, its principal purpose is to lower interest rates, but lower interest rates would not do much to stimulate investment when the cost of capital is already low by historical standards. By contrast, public investment can enhance private investment in two ways. It can increase the efficiency of existing investment and resources. And it can "crowd in" private investment by making new private investment feasible in places where earlier it was not.

The main argument against public investment spending as a counter-cyclical tool is that it takes too long to implement—by the time public projects are approved and implemented the economy is on the way to recovery. But this is not to suggest using public investment as a classical counter-cyclical measure. The economy is not facing a business inventory recession; it is still struggling with the legacy of the bursting of the tech bubble and the follow-on housing bubble. In this case, a healthy dose of public investment spending is a necessary preventive measure against a prolonged slowdown caused by an investment stall after the burst of an asset bubble.

*Global Keynesianism Abroad*

A program of expanded public investment spending would be one pillar of a transition strategy to a sustainable faster-growing world economy. The other would be measures to encourage greater middle-class consumption abroad. A better balance between consumption and production at home means more consumption relative to production abroad, especially in the high-savings, newly industrialized, Asian economies. As noted earlier, these economies have experienced rapid productivity gains over the past decade. The goal of American policy ought to be to help these economies translate those productivity gains into rising wages and living standards—so that working men and women there can consume more of what they produce and so that the world economy can grow in a more balanced way.

To achieve this goal, American policymakers need to shift their international economic thinking from the neoliberal, export-oriented nostrums of the 1980s and 1990s to the Keynesian ideas of the 1940s and 1950s, when the United States dramatically expanded its middle class and raised living standards. Rather than encourage emerging economies to develop primarily through the export of manufactured goods and their component parts, U.S. international economic policy should champion middle-class development aimed at increasing domestic consumption. This means helping emerging economies to expand home ownership, invest in public infrastructure, improve public education, build a social safety net, and create more small and medium-size businesses—much as the United States did in the last century. The end goal of this policy should be to build a larger, global middle class in emerging economies, which could relieve U.S. consumers of some of the burden of serving as the main consumer locomotive of the world economy.

The conditions for rebalancing the world economy in this way are present in many newly industrialized economies, where

there is enormous pent-up consumer demand from rising incomes and years of suppressed consumption. Emerging market consumers in these economies have a lot of catching up to do and the increasing ability to do so. In China, for example, there is one car for every 65 people, in comparison to two cars for every three Americans. China has one-half the televisions, one-quarter the computers, and one-third the cell phones per capita as Europe.[8] As important, there is also enormous demand for more spending on education, health care, and housing. The same is true for many of the other fast-growing, newly industrialized Asian economies.

Even though other economies in Asia are richer, the key to increasing consumption in emerging economies is China, which by virtue of the size of its labor force increasingly sets wage levels for both developing countries and newly industrialized economies. An increase in Chinese wages and consumption would give other countries room to let their wages and consumption rise. Chinese officials seem to understand that, for reasons related both to domestic stability and to international concerns, economic growth in the future must be driven by domestic consumption. Accordingly, they have begun to experiment with policies to create a housing mortgage market and to increase spending on health care and education.

But U.S. policy toward China has not been very coherent in reinforcing this interest. U.S. international economic policy needs to do a better job of encouraging this newly announced direction by pushing China on international labor rights as well as intellectual property rights and by using the Organization for Economic Cooperation and Development and the World Bank to help China create a social safety net and to develop a home mortgage market. Because China lacks a real safety net and does not have reliable public systems of health care or education, Chinese workers are engaged in enormous precautionary saving, which is holding down consumption. The best way to reduce this high level of precautionary savings is to help China put in place a modern social safety net and to do a better job of providing education and health care for its citizens.

The creation of a modern safety net will take time, but the government and the corporate sector could increase spending on education and health care in the interim. In addition, the World Bank could do more to support public infrastructure projects and social spending in developing economies to increase consumption. In a truly global economy, the World Bank, the International Monetary Fund, and other international agencies will, from time to time, need to contribute to a counter-cyclical global macroeconomic policy by increasing international public spending. In the short term, the creation of bigger social safety nets in larger emerging economies is critical to a transition to a more sustainable pattern of global economic growth. Over time, it may reduce to some degree the pool of excess global savings (although lower savings rates can be offset by financial reform aimed at improving the efficiency of capital allocation), but the benefits to a more optimal pattern of world economic growth would outweigh any loss to the global pool of capital.

### *Adjusting Our Thinking*

The notion of an economy of abundance and plenty is counterintuitive to the experiences and training of many of today's leading economists and policy makers who are still rooted in the supply-constrained 1970s and 80s. Yet today's economic conditions of rapid productivity growth and excess labor and capital have less in common with those decades than with the bubble years of the 1920s. Thus, both in our domestic and international policies, we may be at risk of repeating, albeit on a smaller scale, the mistake that an earlier generation in the 1920s

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made in not understanding the challenges associated with rapid productivity growth and an abundant supply of labor and capital. Those challenges require us to think more creatively about spreading economic prosperity not only in the United States but also in emerging economies. ●

## Notes

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4. "Plutonomy: Buying Luxury, Explaining Global Imbalances," *The Global Investigator*, October 14, 2005.

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