Green Shoots or Yellow Weeds?

Nouriel Roubini | Jun 8, 2009

New York – Recent data suggest that the rate of contraction in the world economy may be slowing. But hopes that “green shoots” of recovery may be springing up have been dashed by plenty of yellow weeds. Recent data on employment, retail sales, industrial production, and housing in the United States remain very weak; Europe’s first quarter GDP growth data is dismal; Japan’s economy is still comatose; and even China – which is recovering – has very weak exports. Thus, the consensus view that the global economy will soon bottom out has proven – once again – to be overly optimistic.

After the collapse of Lehman Brothers in September 2008, the global financial system nearly melted down and the world economy went into free fall. Indeed, the rate of economic contraction in the fourth quarter of 2008 and the first quarter of 2009 reached near-depression levels.

At that point, global policymakers got religion and started to use most of the weapons in their arsenal: vast fiscal-policy easing; conventional and unconventional monetary expansion; trillions of dollars in liquidity support, recapitalization, guarantees, and insurance to stem the liquidity and credit crunch; and, finally, massive support to emerging-market economies. In the last two months alone, one can count more than 150 different policy interventions around the world.

This policy equivalent of former US Secretary of State Colin Powell’s doctrine of “overwhelming force,” together with the sharp contraction of output below final demand for goods and services (which drew down inventories of unsold goods), sets the stage for most economies to bottom out early next year.

Even so, the optimists who spoke last year of a soft landing or a mild “V-shaped” eight-month recession were proven wrong, while those who argued that this would be a longer and more severe “U-shaped” 24-month recession – the US downturn is already in its 18th month – were correct. And the recent optimism that economies will bottom out by mid-year have been dashed by the most recent economic data.

The crucial issue, however, is not when the global economy will bottom out, but whether the global recovery – whenever it comes – will be robust or weak over the medium term. One cannot rule out a couple of quarters of sharp GDP growth as the inventory cycle and the massive policy boost lead to a short-term revival. But those tentative green shoots that we hear so much about these days may well be overrun by yellow weeds even in the medium term, heralding a weak global recovery over the next two years.

First, employment is still falling sharply in the US and other economies. Indeed, in advanced economies, the unemployment rate will be above 10% by 2010. This will be bad news for consumption and the size of bank losses.

Second, this is a crisis of solvency, not just liquidity, but true deleveraging has not really started, because private losses and debts of households, financial institutions, and even corporations are not being reduced, but rather socialized and put on government balance sheets. Lack of deleveraging will limit the ability of banks to lend, households to spend, and firms to invest.

Third, in countries running current-account deficits, consumers need to cut spending and save much more for many years. Shopped out, savings-less, and debt-burdened consumers have been hit by a wealth shock (falling home prices and stock markets), rising debt-service ratios, and falling incomes and employment.

Fourth, the financial system – despite the policy backstop – is severely damaged. Most of the shadow banking system has disappeared, and traditional commercial banks are saddled with trillions of dollars in expected losses on loans and securities while still being seriously undercapitalized. So the credit crunch will not ease quickly.

Fifth, weak profitability, owing to high debts and default risk, low economic – and thus revenue – growth, and persistent deflationary pressure on companies’ margins, will continue to constrain firms’ willingness to produce, hire workers, and invest.

Sixth, rising government debt ratios will eventually lead to increases in real interest rates that may crowd out private spending and even lead to sovereign refinancing risk.

Seventh, monetization of fiscal deficits is not inflationary in the short run, whereas slack product and labor markets imply massive deflationary forces. But if central banks don’t find a clear exit strategy from policies that double or triple the monetary base, eventually either goods-price inflation or another dangerous asset and credit bubble (or both) will ensue. Some recent rises in the prices of equities, commodities, and other risky assets is clearly liquidity-driven.

Eighth, some emerging-market economies with weaker economic fundamentals may not be able to avoid a severe financial crisis, despite massive IMF support.

Finally, the reduction of global imbalances implies that the current-account deficits of profligate economies (the US and other Anglo-Saxon countries) will narrow the current-account surpluses of over-saving countries (China and other emerging markets, Germany, and Japan). But if domestic demand does not grow fast enough in surplus countries, the resulting lack of global demand relative to supply – or, equivalently, the excess of global savings relative to investment spending – will lead to a weaker recovery in global growth, with most economies growing far more slowly than their potential.

So, green shoots of stabilization may be replaced by yellow weeds of stagnation if several medium-term factors constrain the global economy's ability to return to sustained growth. Unless these structural weaknesses are resolved, the global economy may grow in 2010-2011, but at an anemic rate.

Nouriel Roubini is Professor of Economics at the Stern School of Business, New York University, and Chairman of RGE Monitor (www.rgemonitor.com)

http://www.rgemonitor.com/roubini-monitor/257017/green_shoots_or_yellow_weeds_latest_project_syndicate_op-ed