'It Will Be Terrible'

Economists in Davos Look with Concern to 2010

By Anne Seith in Davos

AFP

Many in Davos were skeptical about the speed with which the global economy might recover.

Many countries have started to see a rebound from last year's economic recession. But will it last? Economists at the World Economic Forum in Davos warn that paying down massive public debt will be "very, very painful." Deep spending cuts and significant tax hikes may be unavoidable.

For those now in their 30s, Kenneth Rogoff has bad news. "It will be terrible for you," the Harvard University economics professor told a young German at the World Economic Forum in Davos. "Germany's debt is exploding, the population is aging," he said. "And to be honest, I think your country is going to have average growth of just 1 percent in the coming years."

Rogoff went on to say that, should Germany wish to begin making inroads into its mountain of debt, there is no way around strict savings measures and significant tax increases. "It will be very, very painful," Rogoff said, adding that it will take at least a decade, and possibly many more, for Germany to pay down its debt.

He wasn't the only one in Davos with a dark vision of the future. Many countries could be stricken with the "Japan illness," Robert Shiller, a behavioral economist at Yale University, told SPIEGEL ONLINE. Following a financial crisis in the 1980s, Japan's economy remained in the doldrums for years as trust in the economy's ability to recover evaporated. Few were willing to take risks, sapping the Japanese economy of its life blood, said Shiller. "Such a situation could take hold in many regions of the world."

Such prognoses raise questions about the recent global economic recovery, modest though it may be. Is a second recession just around the corner, part two of what some warn could be a "double dip?" In the fourth quarter of 2009, the US economy grew by an impressive 5.7 percent -- but how durable are such gains?

'Historically Exceptional'

One thing is clear: 2010 presents steep challenges to the world economy. "There is an illusion of normalcy," Rogoff warns. But that illusion, he points out, comes largely as a result of the immense amount of money pumped into the economy by governments around the world. The result -- massive public debt across the globe -- is "historically exceptional," Rogoff says. The only comparable situation can be found during the Great Depression, he points out.

The question now is when to shift priorities. When can one begin focusing on paying down public debt without immediately stifling the fragile recovery? And, of course, will taxpayers play along?

"In the US, for example, any politician who tries to significantly raise taxes would be gone immediately," Rogoff is convinced. "We haven't had to tighten our belts for 50 years." Shiller says he can already sense a widespread feeling of anger among his compatriots -- a degree of anger, he said, that hasn't been felt among the America populace since the Vietnam War.

The situation isn't much different in many other countries in the industrialized world.

Conducive for the Rumor Mill

It is the situation in Greece, however, that shows just how dangerous the situation has become. The country is facing public debt that is 110 percent of its GDP -- a state of affairs which has proven conducive for the rumor mill. Last week, it was said that Greece was looking for money from China; others reported that Athens might extract itself from the common European currency, the euro; still others said that Germany and other EU countries were preparing a bailout package for Greece.

Denials from the Greek government did little to help. Greece saw its borrowing costs rise sharply amid a hike in interest rates. "Such stories frighten investors," says Shiller.

It might only be a matter of time until similar stories destroy investor confidence in other countries too. "Currently, the world is still keen to lend us money," said Rogoff referring to the US. "But that will not continue forever."

In Europe there are already warnings that a domino effect could spread from Greece. The finances of countries like Ireland, Spain and Portugal are in a similarly sorry state.

Stress Test for the Euro

The Greek crisis is also a dangerous stress test for the euro, as it presents the rest of the euro-zone members with a tricky dilemma. If they were to help out Greece financially, it would set a risky precedent -- other countries with shaky finances could in the future rely on being bailed out in an emergency. The financial markets would suddenly require risk premiums for bonds even from countries like Germany, because of the possibility that they might have to rescue their weak neighbors.

But if the euro-zone members were to leave Greece to its own devices and the state went bankrupt, the impact on the single currency would be disastrous. "The euro is getting more and more important as a reserve currency," says Shiller. "People believe that euro-denominated debt is safe." A state bankruptcy would profoundly shake that confidence, Shiller warns.

There are also those who are spreading cautious optimism and drawing attention to glimmers of hope. The head of the International Monetary Fund, Dominique Strauss-Kahn, said in Davos that growth was returning faster than expected. He pointed to the fact that Asia has already almost completely recovered from the crisis, with the Chinese economy growing by 8.7 percent last year.

Industry in Turmoil

It seems that 2010 will be the decisive year. As well as showing whether the recovery is sustainable, this will also be the year when the international community finally puts concrete proposals on the table regarding the implementation of the G-20's much-discussed goals.

Barack Obama's recent proposals to separate traditional commercial and investment banks and to stop banks from engaging in so-called proprietary trading with their own money, have added plenty of fuel to the debate. The international financial services industry is in turmoil as a result of the plan.

Few bankers have responded to the ideas as calmly as Martin Blessing, the head of Germany's Commerzbank, who told the *Frankfurter Allgemeine Sonntagszeitung* that "the basic idea is reasonable." "We have seen over the last two years that the current system has flaws and we can not just return to normalcy."

At the beginning of the summit, Deutsche Bank CEO Josef Ackermann had warned against Obama's plan. "In the end, we could all be losers if we no longer have efficient markets," he said.

'No Impact on Policy'

On Saturday in Davos, Ackermann and other financial representatives met behind closed doors with politicians such as French Finance Minister Christine Lagarde, her British counterpart Alistair Darling, EU Economic Affairs Commissioner Joaquin Almunia, ECB President Jean-Claude Trichet and IMF Managing Director Dominique Strauss-Kahn.

However, it appears that little agreement was reached. American Congressman Barney Frank, who heads the House Financial Services Committee, said after the meeting that the Obama administration was determined to push through "tough, sensible regulation." "It is very important to tell the banks and hedge funds what we will do," he added. Asked about the reaction from the financial world, Frank answered: "It doesn't concern me. That has no impact on policy."

However, Rogoff is skeptical about the degree to which Obama's proposals can be put into practice or if they can serve as an example for the rest of the world. "Obama has already made many good speeches," he says. The question is whether he will obtain the necessary majorities to make his ideas reality.

http://www.spiegel.de/international/business/0,1518,675295,00.html