

## The world cannot grow its way out of this slowdown

By Kenneth Rogoff

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As the global economic crisis hits its one year anniversary, it is time to re-examine not just the strategies for dealing with it, but also the diagnosis underlying those strategies. Is it not now clear that the main macroeconomic challenges facing the world today are an excess demand for commodities and an excess supply of financial services? If so, then it is time to stop pump-priming aggregate demand while blocking consolidation and restructuring of the financial system.

The huge spike in global commodity price inflation is *prima facie* evidence that the global economy is still growing too fast. There is nothing sinister in this. The world has just experienced perhaps the most remarkable growth boom in modern history. Given the huge cumulative rise in global growth during the 2000s it is little wonder that commodity suppliers have found it increasingly difficult to keep up, even with sharply rising prices.

For many commodities, particularly energy and metals, new supply requires long lead times of five to 10 years. In principle, the demand response is more nimble, but it has been greatly dulled by a wide variety of subsidies and distortions in fast-growing emerging markets.

Absent a significant global recession (which will almost certainly lead to a commodity price crash), it will probably take a couple of years of sub-trend growth to rebalance commodity supply and demand at trend price levels (perhaps \$75 per barrel in the case of oil, down from the current \$124.) In the meantime, if all regions attempt to maintain high growth through macroeconomic stimulus, the main result is going to be higher commodity prices and ultimately a bigger crash in the not-too-distant future.

In the light of the experience of the 1970s, it is surprising how many leading policymakers and economic pundits believe that policy should aim to keep pushing demand up. In the US, the

growth imperative has rationalised aggressive tax rebates, steep interest rate cuts and an ever-widening bail-out net for financial institutions. The Chinese leadership, after having briefly flirted with prioritising inflation (expressed mainly through a temporary acceleration in renminbi appreciation), has resumed putting growth as the clear number one priority. Most other emerging markets have followed a broadly similar approach.

Dollar bloc countries have slavishly mimicked expansionary US monetary policy, even in regions such as the Middle East, where rapid growth is putting huge upward pressure on inflation. Of the major regions, only Europe, led by the European Central Bank, has resisted joining the stimulus party so far. But even the ECB is coming under increasing domestic and international political pressure as Europe's growth [decelerates](#).

Individual countries may see some short-term growth benefit to US-style macroeconomic stimulus, albeit at the expense of loosening inflation expectations and possibly paying a steep price to re-anchor them later on. But if all regions try expanding demand, even the short-term benefit will be minimal. Commodity constraints will limit the real output response globally, and most of the excess demand will spill over into higher inflation.

Some central bankers argue that there is nothing to worry about as long as wage growth remains tame. True, globalisation continues to shrink unskilled labour's share of global income. But as goods prices rise, wage pressures will eventually follow. As Carmen Reinhart and I have shown in our [research](#) on the history of international financial crises, governments in every corner of the world showed themselves perfectly capable of achieving very high rates of inflation long before they had the assistance of modern unions\*.

What of the ever deepening financial crisis as a rationale for expansionary global macroeconomic policy? It is hard to see the argument in emerging markets where inflation is raging, but even in epicentre countries it is becoming increasingly dubious. Inflation stabilisation cannot be indefinitely compromised to support bail-out activities. However convenient it may be to have several years of elevated inflation to help bail out homeowners and financial institutions, the gain has to be weighed against the long-run cost of re-anchoring inflation expectations later on. Nor is it obvious that the taxpayer should absorb continually rising contingent liabilities (such as increased backing for Fannie Mae and Freddie Mac, the giant US mortgage agencies).

Indeed, if financial firms are not going to be allowed to go out of business, how exactly do central banks and regulators intend to effect the shrinkage of the financial industry commensurate with the sharp fall in key lines of business related to mortgage securitisation and derivatives? Perhaps regulators hope firms will shrink 10-15 per cent across the board. But this is seldom how consolidation works in any industry. Rather, the weakest firms go out of business, with their healthy parts being taken over, or pushed aside by better run institutions. Is every failure evidence of a crisis?

The airline industry often goes through periods of excess capacity, with giant companies going out of business or merging. Yet, we have grown accustomed to these traumas and learned to live with them, as in many other industries. Is it right to let the banking industry hold nations hostage each time they experience consolidation? As major central banks extend their

discount windows to complex investment banks whose business lines are evolving and churning constantly, “crises” of consolidation are surely going to become more frequent.

For a myriad reasons, both technical and political, financial market regulation is never going to be stringent enough in booms. That is why it is important to be tougher in busts, so that investors and company executives have cause to pay serious attention to risks. If poorly run financial institutions are not allowed to close their doors during recessions, when exactly are they going to be allowed to fail?

Of course, today’s mess was many years in the making and there is no easy, painless exit strategy. But the need to introduce more banking discipline is yet another reason why the policymakers must refrain from excessively expansionary macroeconomic policy at this juncture and accept the slowdown that must inevitably come at the end of such an incredible boom. For most central banks, this means significantly raising interest rates to combat inflation. For Treasuries, this means maintaining fiscal discipline rather than giving in to the temptation of tax rebates and fuel subsidies. In policymaker’s zealous attempts to avoid a plain vanilla supply shock recession, they are taking excessive risks with inflation and budget discipline that may ultimately lead to a much greater and more protracted downturn.

*\* This Time is Different: A Panoramic View of Eight Centuries of Financial Crises, NBER Working Paper 13882, March 2008*

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## Paul Krugman’s reply

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### **The Rogoff doctrine**

Ken Rogoff is one of the world’s best macroeconomists, so I take whatever he says seriously. But — you know that’s the kind of statement that is followed by a “but” — I’m having a hard time understanding his [demands for a world slowdown](#).

Ken tells us that

The huge spike in global commodity price inflation is prima facie evidence that the global economy is still growing too fast.

And then he calls for

a couple of years of sub-trend growth to rebalance commodity supply and demand at trend price levels

Um, why? Basically, the world is employing rapidly growing amounts of labor and capital, but faces limited supplies of oil and other resources. Naturally enough, the relative prices of those resources have risen — which is the way markets are supposed to work. Since when does economic analysis say that the way to deal with limited supplies of one resource is to reduce employment of other resources, so that the relative price of the limited resource returns to “trend”?

Presumably there’s some implicit argument in the background about why a sharp rise in the relative price of oil is more damaging than leaving labor and capital underemployed. But that argument isn’t there in Ken’s recent pieces. Model, please?

I agree that

Dollar bloc countries have slavishly mimicked expansionary US monetary policy

and that’s a real issue: the Fed is pursuing very loose policy to deal with a US financial crisis, and that’s inflationary in countries that are pegged to the dollar without facing our problems. But that’s an argument for breaking up Bretton Woods II; it’s not an argument for tighter Fed policy.

Since this is coming from Ken Rogoff, I assume that there’s some deeper analysis here. But I can’t infer it from the articles I’ve read. Please, sir, can I have some more?