*The real threat to global recovery.*

# Governments and Growth

**BY SAMUEL BRITTAN**

A favorite game at this stage of the business cycle is to ask "Where will growth come from?" The American version is to ask where the extra demand will come from when the fiscal stimulus has worn off and real interest rates, hitherto only slightly above zero, return to normal. These questions keep analysts from the breadline. But they are as futile as they are unanswerable.

Indeed they go back centuries. So-called wise men used to ask where the growth would come from after every family was equipped with an automobile and after that when most families had two of these vehicles. Then they asked what would happen after everyone was computerized. Earlier on they no doubt asked what would happen when every household was equipped with a horse and buggy.

The real answer to such pondering is "no such luck." If all human wants could be satisfied by a few hours labor with the aid of modern technology, we would have a Utopia rather than a slump. For it would mean that the age-old problem of scarcity had gone, that we could have as many material goods as we desired, and we would be back to the other old chestnut: How will people spend their leisure in a era of abundance?

The English philosopher and economist John Stuart Mill was one of the first to see that a so-called "stationary state" could be a state of bliss rather than a hell on earth. Not only would there be the material advantage of all of us having enough, but the life would no longer consist of elbowing other people out of

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THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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the way to secure an advantage; and attention could shift to more worthwhile matters. This is all discussed very clearly in Mill's *Principles of Political Economy* (published in the middle of the 19th century, but just as relevant today).

The reason why the age of abundance has not arrived even in the developed Western world is that human wants seem insatiable. No sooner is one desire satisfied than others emerge. People want a second home, a swimming pool, or a flashier car than their neighbors. Some of the new desires represent people's emulation of their neighbors; but some are more positive. To take a clichéd example: Despite all the moans about the decline of interest in classical music, millions more people are able to listen to symphony concerts than ever before in human history because of developments in broadcasting and recording technology.

It is certainly possible and in my view desirable that the push for output and income expansion at all costs may slow down. It would not really be so tragic if either the national income per capita or people's personal incomes were to grow at an average of a zero to one percent rather than two, three or four percent. This would arise if there were a change of tastes in favor of leisure or a less hectic form of working life. The policy problem would then be to distinguish between a genuine change of tastes and a temporary failure of the economic system of the kind that occurs in recessions when idle hands sit side by side with unsatisfied wants. A sign of such a fundamental change in tastes might be a slowdown in GDP growth arising from a voluntary reduction in working hours and longer holidays. But there would be more subtle signs. For instance, businesses that pride themselves on hectic and highly driven career structures would find it harder to recruit executives in competition with rivals offering a more laid-back existence.

Although it is never too early to start thinking of such problems of success, we are not there yet. There is still a demand for whatever extra output the economic system can provide, so long as there is sufficient flexibility to adjust to changes in technology and consumer desires. Against this background the growth problem is not the fundamental one of income versus leisure, but how to keep demand and potential output roughly in balance without undesired idleness or inflationary overstrain.

Even here there is too much worry and policy activism. Let me lay down a simple proposition which might still be controversial. This is that the natural tendency of any advanced modern economy is to grow at a rate determined by factors such as productivity, population growth, and participation rates—that is the percentage of the adult labor force in the labor market. The OECD puts the underlying growth rate of the United States given by such factors as around 3.75 percent annually. This may be on the high side, but within the ballpark. In Europe it is more like 2–2.5 percent, and much dispute about whether the United Kingdom, after lagging for decades, is or is not now on a faster growth path than Donald Rumsfeld's "Old Europe."

The controversial part of my proposition is that most of this growth takes place automatically without special policies, ministerial exhortation, and all the other phenomena about which commentators and journalists become so excited. There is no great mystery about how this happens. In the face of gradually rising productivity, either prices will fall slowly, thus automatically increasing domestic purchasing power, or wages will gradually rise increasing it in another way. There is a lot of confusion between macro and micro forces. Even if policymakers settle for price stability or a low positive rate of inflation, some individual prices are bound to fall—computers and associated products being the obvious example. When competitive forces gather steam and particular sectors come under pressure we must expect to hear harassed cries of "deflation." These are now not quite as fashionable as they were a year ago, and in the United States at least some of the talk has shifted from deflation worries to talk of inflation being too low. This is somewhat puzzling when the consumer price index is 2 percent above a year ago.

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It is true that unit labor costs in U.S. manufacturing fell slightly in 2002. But they are only one sector of the U.S. economy and are now rising again.

The brief answer to what will happen to the U.S. economy when the fiscal stimulus provided by President Bush's tax cuts and spending increases wears off is that economic expansion will indeed slow down. But it will need to do so. If the OECD and similar organizations are right, output is, taking one quarter with another, growing faster than productive potential. Any attempt to continue expansion at this rate would lead to inflationary overstrain.

Alarm is sometimes expressed because U.S. unemployment is now at 6 percent compared with 4 percent a couple of years ago. But we really do not know how large a statistical unemployment percentage is required as a safety valve to provide for economic change. A few years ago the "natural rate of unemployment" at which the U.S. economy could settle down was put at 5 percent. But during the height of the recent boom some economic commentators thought 4 percent, the then-prevailing rate, would become normal. The only real answer is to suck it and see, and to concentrate on supply side measures to make it easier to change jobs and retrain, and to dismantle cartel-like devices by unions and employers that prevent individual wages and prices adjusting to market conditions.

The recent OECD *Economic Outlook* takes a fairly benign view of the immediate future. World growth is projected to recover to, or exceed, trend rates. It is unbalanced, as so often happens in the real world, with the U.S. growing more than twice as fast as Japan or the euro area. But the interest of the publication lies not in the central forecasts but in the risks that the OECD identifies. The value of the report has been much improved by having one human being, Jean-Philippe Cotis, the chief economist, signing and taking responsibility for it.

Five main threats are identified. The report is understandably reluctant to stick its neck out on the stock market. But, although the market indices in the United States are below their peak levels of 2000, it is far from certain that "irrational exuberance" has been expunged. The OECD does go as far as warning that if interest rates or the equity risk premium were one percentage point higher, U.S. equity prices would be vulnerable. It cannot of course be the role of central banks to guarantee any particular level of equity prices. They can only react indirectly if equity booms or busts threaten to produce a shortfall or excessive growth in final demand.

The second threat arises from the boom in house prices in some countries together with the associated increase in consumer indebtedness. In the United States, the boom has been comparatively gentle, with the net increase well under 50 percent, starting from 1985. The sharpest increase in housing prices has been in Spain where they are now more than 300 percent of their 1985 level. The runners-up include Ireland, the United Kingdom, and Australia where they have risen to 200 or 250 percent of their former level.

The United Kingdom is particularly vulnerable. Net housing wealth is reckoned to be 300 percent of household disposable income. The OECD estimates that a 10 percent decline in real housing wealth may reduce consumption by over 1 percent in the long run and by good deal more on immediate impact. But central banks can no more target the real estate market than they can the stock market. The Bank of England is perhaps open to criticism for having relied on rising consumer indebtedness backed by rising house prices to fuel demand for too long, when other sources such as investment and exports were flagging. It suffers from a persistence of the fine-tuning mentality which confuses a reasonable attempt to keep growth on trend over the medium term with a dangerous intolerance of quarter-to-quarter fluctuations which are inevitable in a changing world economy.

A third source of vulnerability identified by the OECD consists of what it calls "corporate pension funding gaps." In the United States, some estimates point to a shortfall of $220 billion in U.S. corporate pension fund assets compared with liabilities for the 500 companies in Standard and Poor's index alone. Similar gaps are identified in the United Kingdom, Canada, and elsewhere. But lack of data prevents a comprehensive analysis. The dangers here are that rating agencies and investment analysts will downgrade the sponsoring companies; that corporate funds are diverted from capital spending to plugging the pension funding gap, and that pension

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contribution rates are raised, putting pressure on household consumption; and that worries about the ability of defined benefit schemes to pay out pensions in the future increase precautionary saving and thereby reduce consumption.

Some of these dangers may offset each other. For instance, a fourth threat mentioned by OECD is that too many countries, and above all the United States, have structural budget deficits above anything that can be explained away by the business cycle. Although these will need to be tackled eventually, present deficits could offset any threat of private-sector oversaving arising from any stock market or real estate shake-out or corporate pension concerns. The motto here should be St. Augustine's "Make me virtuous but not yet."

The fifth threat mentioned by the OECD is altogether more serious. This arises from the large and increasing U.S. current account deficit, already over 5 percent of GDP which is quite unusual in the early stages of a recovery. In my view the danger arises not so much from the deficit but from the possible U.S. policy reaction.

Left to itself, the foreign exchange market would take care of much of the problem. There has been a shift in the financing of this deficit from overseas long-term direct investment to reserve accumulation by central banks, especially that of China, and also to "unidentified" (meaning largely speculative and volatile) short-term capital inflows.

As U.S. Federal Reserve chairman Alan Greenspan recently remarked, the rapid growth in the Chinese money supply will at some point cause the Chinese economy to overheat or force the Chinese authorities to stop intervening to buy dollar assets. Either way there would be a real revaluation of the Chinese currency against the dollar. If U.S. policymakers could only keep their mouths and elbows out of the way, the markets could bring about the fall in the dollar required to produce a better overseas balance. This would need to be backed by action to reduce the U.S. domestic budget deficit after the presidential election. Unfortunately, however, the U.S. administration has been engaged in a series of ill-founded and perverse actions to try to hurry the process along. The recent increases in steel tariffs, although reversed, and the restrictions on Chinese imports suggest a lack of comprehension of the basis of international trade despite the billions that have been devoted to so-called economic education in the United States.

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By pressing for Chinese revaluation, the U.S. Treasury is playing with fire. Surely by now American Treasury secretaries should have learned that by far the best policy is to say nothing whatever about the desirable value of their own or other people's currencies. I would guess that more U.S. Treasury secretaries have lost their jobs from unfortunate remarks about exchange rates than from any other cause.

If the Chinese take the Americans at their word and really do stop accumulating dollar assets, there will be a sharper fall in the dollar than anyone has bargained for and also a rise in American long-term interest rates which could more than offset any stimulus from a lower dollar.

One way or another a revaluation of the renminbi against the dollar is likely. Indeed it may not be too long before U.S. concern about an excessively high dollar is replaced by a fear that the dollar has fallen too far. You do not need a crystal ball to see this—simply look at the record. In 1984, the United States initiated the Plaza agreement to knock the dollar down. By 1985 it signed the Louvre accord to try to prevent the dollar from falling too far. James Baker, U.S. Treasury secretary at the time, is still very much on the scene under the George W. Bush regime.

Nothing will prevent jerky rearrangements in the real world; but inevitable fluctuations are made a great deal worse by the efforts of governments to preside over and force the pace of change. Nor can coming elections be treated much longer as an excuse. The United States has presidential and/or congressional elections every two years. There is scarcely ever a breathing space when electoral considerations are absent. It is not impossible for democratic governments to rise above them. Otherwise we would never have had the post-war multilateral trading system and the GATT and its successor, the WTO. Those who start by beggaring their neighbors are likely to end up by beggaring themselves. ◆