POINT OF VIEW

Growth after the Crisis

Francesco Giavazzi

If the world economy is to recover, a replacement must be found for the newly frugal U.S. consumer

Photo shows a deserted shopping mall near Washington, D.C., on a Friday afternoon.

U.S. consumers, for decades the driver of the world economy, appear to have retrenched for the long haul.

To get a sense of magnitudes: U.S. private consumption was about $10 trillion in 2008 and European Union consumption accounted for about $9 trillion. Asian consumption was less than $5 trillion. Before the crisis, U.S. private consumption accounted for about 16 percent of global output. It is not surprising that the economizing by U.S. consumers has pushed the world economy into a deep recession. Nor it is surprising that demand expansion in emerging countries—such as China, India, and Brazil—though on the rise, cannot compensate for the fall in U.S. buying.

Christopher D. Carroll, a Johns Hopkins University economist who has studied the behavior of U.S. consumers for more than a decade, predicts that U.S. households, spooked by the recession, will increase savings to about 4 percent of disposable income—that is, income after taxes. That's the level at which U.S. households saved in the mid-1990s, before they went on a spending spree that reduced savings to almost zero in the years before the crisis. Disposable income is about 70 percent of gross domestic product (GDP), so a 4 percent increase in the household savings rate would translate into a fall in household consumption of about 3 percent of GDP.

To compensate for declining consumer spending and reduced business investment, many governments have boosted public spending and cut taxes, increasing government deficits in the process. But government stimulus is a short-term prop. Deficits are unsustainable in the long run. Prosperity will eventually require the recovery of consumer and business spending. In fact, even though private demand has yet to recover, policymakers are contemplating how and when to begin to reduce or remove their stimulus packages and shift fiscal balances back toward equilibrium without pushing the world anew into recession (see "Sustaining a Global Recovery" on p. 8 in this issue).

How will the world replace a reduction in global demand as large as 3 percent of U.S. GDP when governments begin their inevitable fiscal consolidation? That is the major issue confronting policymakers and economists.

Many observers think that the answer, in the medium term, is an increase in domestic demand in China. But that seems unlikely. For some time at least, China will be unable to replace a loss of demand as large as 3 percent of U.S. GDP. The Chinese economy is one-third that of the United States. So to replace the decline in U.S. demand, China's spending would have to increase by about 10 percent of GDP. This is possible, but would require major reforms. China today saves some 40 percent of its GDP—half by households, the other half by firms.

China savings

The factors that underlie that enormous savings rate are unlikely to change quickly. Chinese firms save that much because the banking system still favors state-owned enterprises and lacks the culture of financing a promising private-sector project. Household savings are mainly precautionary because the country lacks a public safety net and has few risk-sharing financial products, such as health insurance, life insurance, and pensions. While Chinese authorities have been aware of these problems for many years, reforms have been slow. Since the start of the crisis, the Chinese government has used public spending—mostly in new infrastructure—to offset the fall in export demand. But some signs suggest that the productivity of additional infrastructure spending is decreasing. What China needs is unemployment insurance, public pensions, health insurance, public schools, and a new banking culture. Until those materialize, the private saving rate will remain enormous and private spending, correspondingly depressed.

China doesn't have to make up for the entire decline in U.S. consumption. Demand could also expand in countries such as India and Brazil, but, given the size of these economies, it is unlikely that they will be able to compensate fully for the fall in U.S. consumption. Of course Europe could step in, but Germany, at the core of the European Union, has traditionally been an export-led economy, unable to grow from internal demand, let alone provide a demand stimulus to the rest of the world.

Is there a way out of this deadlock? Maybe U.S. consumer demand does not have to be replaced entirely and immediately by consumer demand in other countries to restore full employment in the world. Consider the problem from a different perspective—based on the underlying concepts of the growth model for which Robert Solow won a Nobel Prize in 1987. For the world economy to be in full employment, savings must equal investment. If the world saving rate increases (and it will if the increase in the saving rate of U.S. consumers is not offset by large enough reductions in the saving rate in other countries), the only way to maintain full employment is through higher investment.

This has, in part, already happened through the increases in public investment that were part of the stimulus packages in many countries. But relying on higher public investment for the longer term has two problems:

- To restore goods market equilibrium in the world, public investment—for instance, in the United States—would have to double, from less than 3 percent to almost 6 percent of GDP. It is unclear whether such a large increase in public investment would be feasible: in the gigantic American Recovery and Reinvestment Act of 2009, the increase in U.S. public investment amounts to less than 1 percent of GDP a year.
- Any increase in public investment carries with it the high probability that some of it will be wasted rather than contributing to raising the productive level of the capital stock—as I noted, some of this seems to be happening in China now.

Private investment, which accounts for a much larger fraction of GDP (close to 20 percent in the United States), is a more likely candidate to plug the spending gap than is public investment. But what would induce firms to raise investment spending in the middle of a sharp recession? A technological breakthrough—such as the internet revolution that began in the mid-1990s—does not seem to be on the horizon.

What could give rise to a new round of private investment is the realization that the crisis will change the composition of world demand for the long term. To address such a change, the structure of world output would have to adjust, which requires industrial restructuring and, as a consequence, new investment.

Demand composition shifts

If U.S. consumption will be permanently lower, and consumption in the emerging and developing markets eventually higher, then the composition of world demand will change because the composition of a country's consumption depends on its per capita income. This means that the type of goods demanded will change. We already see something like this coming: primary commodity producers (in Latin America, in particular) are benefiting from the demand shifts toward China and India. Although demand for, and prices of, primary commodities declined during the recession, they have begun to climb again. It is demand for high-end German cars that has virtually disappeared. Adjusting the structure of world production to such a change in the composition of world consumption cannot happen without substantial restructuring, and, therefore, substantial investment.

Thus a permanent increase in the U.S. saving rate could be offset, at least in part, by an increase in private investment. What would prompt firms to invest is the anticipation of a change in both the geographic allocation and the composition of consumption—relatively more consumption in China, relatively less in the United States; higher demand for such things as basic appliances and relatively lower demand for high-end automobiles.

This observation has an interesting corollary. Those countries that invest in restructuring today will emerge from the transition with a higher (per capita) capital stock and, therefore, a higher per capita income. Those countries that do the restructuring—and get it right, including the portion that happens through public investment—will come out of the crisis richer. ■

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