Capacity to generate global economic growth "under question"

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Recent speeches by European Central Bank (ECB) president Mario Draghi and Benoit Coeuré, a member of the ECB executive board, pointed to the worsening state of the global economy and the air of perplexity descending over key policymaking bodies as they consider what to do about it.

Delivering a lecture at the University of California Berkeley on Saturday, Coeuré indicated that the assumptions that governed policy discussions in forums such as the International Monetary Fund, the G7 and the G20 over the past two decades were increasingly no longer applicable.

Coeuré said the "capacity of the global economy to generate growth is under question" and policymakers "lack a clear vision of … the broader design of the global economy, which will support growth."

There was evidence that freely floating exchange rates, one of the key foundations of policy over the past 20 years, may not make economies more resilient, he said. And there were concerns that financial integration and global financial flows may have made the world riskier, contrary to previous beliefs.

Coeuré said the present model, based on the prescription that economies hit by a downswing should seek to export their way out, was not a "sustainable global growth model." That was because it was based on the "fallacy of composition," which broke down when all economies are hit by the same shock, or a set of positively correlated shocks. "By definition, not all jurisdictions can simultaneously run a current account surplus," he said.

If every economy responded to economic challenges by seeking a solution through exports "it would only trigger a race to the bottom." In other words, each country would attempt to boost its export position by lowering the value of its currency, cutting costs at home, thereby reducing demand, leading to a further decline in global growth and triggering further currency devaluation and cost-cutting.

Coeuré pointed to the decline in real investment spending as a critical factor in the decline in global growth. "In the euro area in particular, private investment is not playing the accelerating role that one would expect at this stage of the business cycle, despite domestic demand gradually strengthening," he said. "One reason for that is the depressed expectations of future potential growth, which lead firms to expect permanently lower incomes and profits."

The ECB board member did not spell it out, but this is a description of the vicious economic circle now in operation. Global growth is slowing because of the fall in investment. At the same time, the decline in this form of business spending is further depressing growth, leading to more cutbacks in investment because of diminished profit opportunities.

Public investment is not providing a counter-balance to the fall-off in private investment demand because governments are cutting back spending in order to reduce deficits and debt.

Coeuré noted that "structural reform" was a term that policymakers often liked to utter but it was often "too vague to be meaningful" and, insofar as it targeted labour markets, could add to a "deflationary wage/price spiral." That is, the driving down of wages leads to cuts in consumption demand, leading in turn to deflation and falling growth.

Reporting on the speech on the Australian web site *Business Spectator*, columnist Alan Kohler noted that Coeuré indicated that central bank policies aimed at lowering interest rates could not produce growth when debt is already high and governments and firms are not investing.

"More fundamentally," Kohler continued, "he's saying that policymakers don't actually know what to do any more."

A speech delivered by ECB president Draghi to a banking conference in Frankfurt the previous day also indicated growing economic problems, despite Draghi's assertions in opening his remarks that "economic recovery" was on a "firmer footing" in Europe than a year ago.

The rest of Draghi's speech pointed to developments that make clear that this "positive picture" may be of short duration. Growth momentum remained weak and the "headwinds blowing from the global economy have increased," he said. Inflation still remained "well below" the ECB's target of close to 2 percent.

Draghi warned that downside risks to the euro economy rose in recent months due to the "deterioration in the external environment." The outlook for global demand worsened, especially in emerging markets, while uncertainty in financial markets increased.

Even when those "headwinds" were factored in, the "strength of the underlying recovery is modest." Important "tailwinds," most notably the lower price of oil, might have been expected to provide a boost, along with monetary policy that had never been as supportive as at present.

Draghi noted that the recovery remained "very protracted" when placed in an historical perspective. "It took between five and eight quarters for the countries now making up the euro area to recover their pre-recession level of real output after the slumps of the 1970s, 1980s, and 1990s. During the recent recession … it took the US economy 14 quarters to reach its pre-crisis peak."

On current estimates by the ECB, he continued, it would take the euro area 31 quarters just to get back to the pre-crisis level of output, that is, not until the first quarter of 2016.

This points to why the current economic models are breaking down. It is because they make an analysis of post-2008 developments as if the financial crisis were simply a downturn in the business cycle, albeit a severe one. In fact, the 2008 crash signified a breakdown in the functioning of the world economy.

History, of course, does not repeat itself, but probing historical parallels does provide important insights. The outbreak of World War I, as Leon Trotsky explained, was a result of the breakdown of the global economy. During the middle years of the 1920s, following a deep recession at the commencement of the decade, economic growth proceeded at a very slow pace. The debate in leading economic circles at the time, as at present, was dominated by the question of how to overcome the malaise—all to no avail.

The business cycle continued to operate, with upturns and downturns, but the underlying conditions that existed before 1913–14 never returned. As a result, much of the European economy did not reach pre-war output levels until around 1926–27. Then there was a brief upturn, after which the 1929 Wall Street collapse set off the plunge into the Great Depression.

This history provides a far clearer insight into the prospects for the world economy than all the "models" of the ECB and other major institutions. As even their representatives admit, these models have failed to predict the course of events, let alone provide any answer to stagnation, recession and the threat of another financial crisis.