To the Point

Discussion on the economy, by the Chief Economist

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Happy New Recovery Year!

As 2009 is almost over, and economic developments have turned out more positive than most economists and analysts had envisaged, it is time to look forward. If 2009 was all about stimulus and ways to restart growth engines, the main focus during 2010 will be how to handle sovereign debt and exit strategies.

The recovery is likely to continue, and global growth rates can reach some 3-3 ½ % during 2010, driven mainly by emerging markets with strong fiscal and external balances. Still, many OECD countries will struggle. Budget deficits and public debts are getting uncomfortably high. Households may have doubts about increasing spending, as stimulus may soon be converted into higher taxes and lower public expenditures. Weak corporate sectors with few incentives to enhance investment will also dampen growth prospects. A lot of the upturn during the coming year will be caused by a bounceback from low levels. The numbers will look fine, but in reality they do not provide that much to cheer about.

A Russian expert once told me that Russia's position was never as bad as most people thought when a crisis emerged, but also not as good when the situation started to improve. The same applies to the global economy as it begins its recovery. The outlook is brighter, but many remaining challenges must be faced in order to sustain growth and create a more stable environment.

This last "To the Point" of 2009 will play down discussions on the most reasonable forecast with regard to GDP growth, inflation, sovereign debt, and financial markets. Instead, it will concentrate on the New Year's resolutions that policymakers and business leaders will have to make in order to create a better world economy in 2010 and thereafter.

Challenging New Year's resolutions

We all know that having too many resolutions runs the risk that none of them are taken seriously and the whole thing becomes a fiasco. That is why we stick to only three resolutions, albeit we have to admit they are all full of complex ingredients, thus making them challenging indeed. Voilà!

1) Reform the international monetary and financial system.

2) Boost innovation.

3) Step up microeconomic efforts and reforms, including creating ways to reward long-term developments and soundness.

Create a new monetary and financial system

Chart 1: US current account (rignt hand side)and dollar index (left hand side)

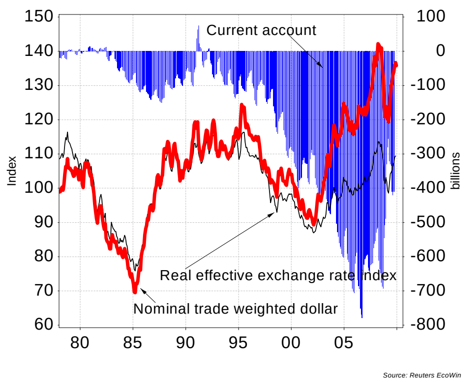
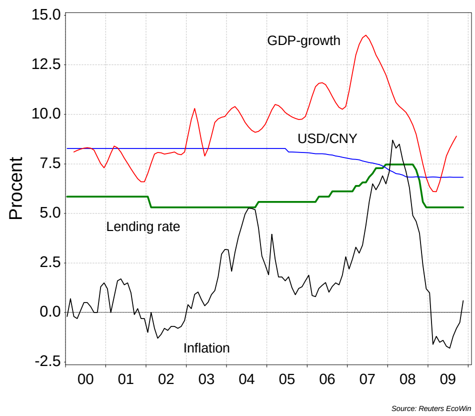


Chart 2: Indicators for China



Percent for all indicators except for the USD/CNY, spot rate

Because of the dollar's dominance in international currency over the last 30 years, it has been easier for the US to finance large deficits with the rest of the world. The inflows of foreign capital became an important cause of the current economic crisis as they contributed to low interest rates, excess liquidity, and loose monetary policy. Globalisation – with stronger competition from mainly China and India - reduced import prices, which also led to lower inflation and interest rates. Together with insufficient financial supervision, the result was overleveraging and the underpricing of risk.

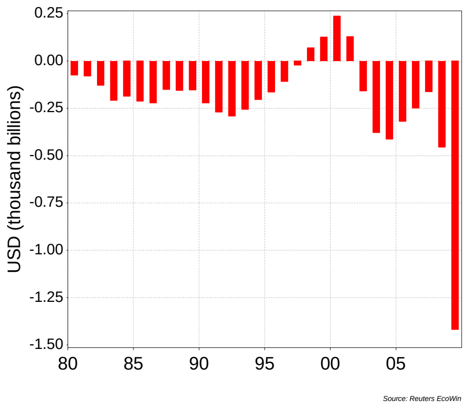
Over the last three years, the US trade and current account deficits have declined sharply, but, absent policy action, they are likely to start climbing again. The main reason is that a larger budget deficit – which is projected to last for at least the next decade – will push up domestic demand and thereby imports as well as inflows of foreign capital, due to the inadequate domestic saving. The vulnerability will thus increase over the next decade or two.

William Cline of the Peterson Institute in Washington has projected that the US current account deficit will reach 15% of GDP in 2030, mainly as a result of worsening public finances. The level of US net debt will reach $50 trillion (compared with $3.5 trillion today), which will equal 140% of GDP. The main problem for the US will be the financing of the debt service that is estimated to absorb 7% of output annually, thus lowering Americans' living standards.

As other countries are either pegging their currency to the dollar (China), or even devaluing (Switzerland) despite already large trade surpluses to become more competitive, the dollar remains overvalued. Almost all countries are trying to export their way out of the crisis, making it more likely that the US will have renewed increases in external deficits, unless there are genuine efforts to adjust to stronger domestic demand in China, Japan, and several European countries. The focus is, of course, also on the US where there is a need to reform social security and increase taxation in order to make public debt more sustainable.

This adjustment and decrease of imbalances would get some help from an evolution of a multiple currency system where also other currencies share the international position in private markets. In addition, enhancing the role of the IMF in issuing Special Drawing Rights (SDRs) to enable countries to build up reserves without running large current account surpluses, would support the reduction of imbalances. The situation may look a lot better at the moment, as the US current account deficit has become smaller, but developments are likely to be reversed within shortly. And the US will not benefit from these developments. More likely, the fiscal position will call for reforms that would make the US economy less vulnerable. If foreign investors stop financing the US deficits (not likely), a

Chart 3: US budget balance 1980-2009



collapse of the dollar and a new recession could ensue. If, on the other hand, the situation returns to the one we had before the crisis, there still would be risks for new financial crises. That is why, under either scenario, we need a reformed global monetary system. In addition, the process to reform the financial architecture must proceed. The outcome must be adhered to by all global players; otherwise, the playing field will not be levelled. The process has started, but much remains to be done during 2010. The most concrete action to reduce the imbalance of the global economy and the medium-term risks would be for the US to signal during 2010 a commitment to introduce – within a few years – the balancing of federal budgets over the business cycle, just like in Germany or Sweden.

Boost innovation

According to Carmen Reinhart and Ken Rogoff, the authors of *This Time it is Different: Eight Centuries of Financial Folly*, high levels of debt are associated with subpar growth. Even if there were to be a decline in the value of the dollar, there would also have to be a sizeable cutback in the US consumption and investment. Besides trying to increase domestic saving and balance the budget, the US and other countries faced with similar challenges, would have to boost growth through higher productivity and enhancement of labour participation. Both the environment and the economy need innovation.

For policymakers, building an environment sufficiently friendly to creativity and innovation would thus be important. Ensuring that there is a good education system to start with, and that there are financing and institutions for research and development, is also critical. Every one of this year's Nobel Prize laureates stressed the importance of having excellent teachers at various levels as factors in their success as researchers.

Also, for business leaders, the buzzword is innovation. How can people come up with groundbreaking ideas in an organisation? Dyer, Gregersen, and Christensen are three professors in leadership or business administration, the latter associated with Harvard Business School. They found in a six-year study that five "discovery skills" were present in those executives who distinguished themselves through their creativity:
1) *Associating* seemingly unrelated questions or problems or ideas, 2) *Questioning* by asking why?, why not?, and what if?, as well as imagining opposites and embracing constraints,
3) *Observing* others in order to get the ideas, 4) *Experimenting* and, 5) *Networking*. Companies that continue to invest in their innovative capabilities during tough economic times are those that fare the best when growth returns. As competition hardens, the focus on innovation will increase. You can copy most products, but you can not easily copy innovation skills. Innovation must be part of all policy makers' and business leaders' New Year's resolutions.

Macro is important – but so is micro

There are still many challenges to face with regard to macro economics, especially in the medium term, although they must be partly dealt with already during 2010. Fiscal imbalances in many countries, risks of defaults, and higher inflation will make financial markets nervous. Higher unemployment is yet another challenge.

Having focused on providing liquidity to institutions and sectors, it is high time to focus on how to improve the functioning of markets and to carry out reforms. Microeconomics is more occupied with how markets work, the way prices are set, and how competition is developing. There are still many product- and labour markets that do not work effectively – for example, in Europe. In the EU, it should now become easier, at least in theory, to apply for jobs in the service markets across countries, but the question is, will this work also in reality.

How to handle structural adjustment – for example, because the car industry is moving to emerging markets - will be the main topic not only in many countries in Europe, but also in the US and Japan. We will never know in advance where new jobs will be found, and therefore it is important to create an environment that encourages new ideas and investments.

To create incentives that are good – not only in the short term but also in the medium and long term – is another challenge. During 2010, decisions have to be taken in which sometimes short-term benefits and costs are weighed against long term ones. Notable examples include: 1) environment and climate change, 2) financial sector sustainability, 3) welfare systems, and 4) trade policies.

There is a need to create better policy decision tools, ones that reward also the long-term developments and soundness of policies. In this respect, since models are still often used for providing guidance to policy decisions, more work must be carried out on how to include the financial sector and wealth/debt balance sheets, as well as environment and climate change in these econometric models. No time to rest. Or as the late Nobel Prize laureate in Economics, Paul Samuelson, once said: “There is no room anymore for comfortable ineffectiveness”. Happy New Year!

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