To the margins of a Nobel Prize winner's ideas Beyond the cycles – long-term challenges of the global economy*

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Lehman Brothers filed for bankruptcy protection on 15 September 2008, ushering in one of the most severe global crises of the past hundred years by aggravating problems that, until then, had been mostly limited to the US subprime mortgage market. Most forecasts had not even hinted at a meltdown of this magnitude. After the initial shock wore off, economists dedicated their attention to analysing the symptoms of the crisis and devising strategies to prevent severe negative repercussions. Although there were some disputes about the prioritisation of the root causes, there seemed to be general consensus about on the fact that what had transpired was a phenomenon that makes an appearance in market economies from time to time: a cyclical boom followed by an enormous bust ("business cycles"). In line with these assessments, during the recovery period beginning from mid-2009 the centre of attention shifted gradually to the shape and dynamics of the expected growth path. Marked by different letters of the alphabet (V, W, U, L), a multitude of scenarios were conceived in close succession.

Clearer knowledge is now available about the consequences. It did not take long for the rapid growth starting in 2009 to lose momentum. Despite protracted periods of extreme monetary easing, the output of numerous advanced economies has still not reached pre-crisis levels. Even where it did, in the foreseeable future it has no chance of approaching the growth rate of the pre-crisis years. The euro area, the most important export market of Hungary, is likely to soon enter the third period of recession. The normalisation of labour market developments is progressing even more sluggishly than growth. Unemployment rates are hovering well above pre-crisis levels, hitting younger generations especially hard. In spite of low interest rates, financial intermediation has sustained long-term damage, while corporations are tending to give up on new projects amid uncertain prospects of

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demand. It appears increasingly evident that this crisis is not like any other. In addition to the deterioration in short-term demand conditions, the longer-term ability of economies to grow has suffered lasting damage.

In recent months, leading contemporary economists have been engaged in active and forward-looking debates at numerous forums about the protracted malaise of the global economy. Presented below is an overview of the most important opinions discussed in these debates as the factors most likely to have an influence on longer-term development trends.[1]

Several fascinating ideas have been proposed to explain the reasons for the sluggish recovery in recent years, perhaps the most recognised of which are those dedicated to synchronised balance sheet adjustment and a number of closely connected theories emphasising the role of financial cycles besides normal business cycles. In addition to normal business cycles, there are so-called financial cycles, which capture the cyclical movement of debt accumulation and debt repayment, materialising both at the individual level and at the level of the total economy. Descending branches of the financial cycle (i.e. when participants are in the process of repaying their accumulated debt) may lead to a weak growth environment that lasts longer than it would in case of a normal business cycle. In this case, the problem of debt overhang has materialised in several economic regions, simultaneously affecting multiple participants (budgets and households). There has thus been a limited opportunity for export expansion, which has served as a way out in other recovery periods when domestic demand dried up. The question is whether this cyclical movement of the economy and financial intermediation can fully explain the outbreak of the crisis and the ensuing slow recovery?

According to many, it cannot. In recent decades, a number of negative trends have evolved in the global economy that had already been predominant before the crisis, even though they received less attention during the years of steady growth. Since these trends have been present nearly continuously since 2009, they may imply the greatest challenge and obstacle to the growth of the global economy in the coming years. At present, one may note the four most frequently analysed factors: high debt levels, increasing income inequality, ageing societies and global warming. Partly individually and partly due to impacts mutually reinforcing each other, these effects may increasingly influence the future of the global economy.

One of the most significant triggers of the 2009 crisis was the excessive growth of debt. Despite the drastic adjustment of the behaviour of indebted participants, global debt-to-GDP has increased further since the crisis. The public debt-to-GDP ratio of advanced economies has reached the peak observed directly following World War II, while the

1 Sources for this paper include analyses from the collection of studies entitled Secular Stagnation: Facts, Causes and Cures (a VoxEU.org eBOOK edited by Coen Teulings and Richard Baldwin, CEPR Press) and interviews with five winners of the Nobel Prize in Economic Sciences published in the Finance & Development magazine of the IMF under the title “Looming Ahead” (September 2014, Vol. 51).

indebtedness of the private sector has risen to unprecedented highs. Taking advantage of a very loose monetary policy environment in recent years, developing economies became indebted rapidly. Currently, the economies of the world see their debt snowballing to unprecedented levels. The combination of subdued growth and low inflation generally impedes improvement in debt-to-income ratios. Besides restraining consumption and the investment decisions of directly affected participants, high debt levels deteriorate macroeconomic predictability in general, which is a key factor from the perspective of longer-term decisions. This latter effect may be a particularly sensitive point, given the prevailing low interest rate environment. Indeed, a rise in interest rate levels would lead to an immediate loss of wealth for savers holding debt instruments and – through an increase in refinancing costs – may push already high debt levels even higher. Centuries of experience suggest that, in the lack of an increase in nominal income, there is little chance of solving the problem without restructuring – or partly waiving – the loans of distressed borrowers.

Analysing the relationship between income inequality and economic growth has become a part of mainstream economic thinking in recent years. The findings of the relevant research indicate that excessive growth in income inequality diminishes the long-term growth potential of the economy. The share of employees in GDP generated has been diminishing progressively for decades. The negative trend looks especially gloomy when the share of wages is examined without the top 1 per cent of income earners. Rising income inequality gives rise to gradually widening gaps in the accumulation of wealth. This trend continued inexorably even after the crisis. According to a recent report, 1 per cent of the global population presently owns nearly half of all global wealth.[2] In addition to obvious social and political risks, there may be severe, longer-term economic repercussions. Social groups in the bottom half of income distribution with a higher propensity to consume fall more and more behind, leading to a loss of demand over the short term. In the long run, this may inflict long-lasting damages on potential growth if the education and healthcare expenditures required for the development and reproduction of human capital are not available. The reduction of income inequality falls mainly in the competence of fiscal, education and employment policy.

The deterioration of demographic trends already poses serious challenges to several developed countries and may materialise as an acute problem in a number of developing economies (e.g. China). As the number of persons employable in the labour market continues to sink, ageing may put increasing pressure on large welfare systems (e.g. education, healthcare) and overstretched budgets. Although deteriorating demographic trends may be cushioned by a strengthening of migration in the short term, in practice this only means a reallocation of the problem between countries. Aside from an improvement in productivity, a long-term solution could only be achieved through the adjustment of the

2 For further details, see the Credit Suisse Research Institute's Global Wealth Report 2014 (October 2014).

retirement age (to reflect the increase in life expectancy) and incentives for parenthood, with contributions being paid over the entire active career.

Finally, the economic consequences of climate change resulting from the extreme weather conditions seen in recent years have become more and more perceivable, even for ordinary people. Without adequate, global-scale intervention, the deterioration of the natural environment and the gradual depletion of resources may become an increasingly significant obstacle to social and economic development. Economic solutions aimed at resolving this problem – through the tax regime, for instance – have been known for a long time. With sufficient political will and globally concerted efforts, a lasting adjustment of the social value system could represent a great step forward.

Even this short list may serve to show that while the current growth deficiencies of the global economy are in part related to the special cyclical characteristics of the 2008–2009 crisis, they are likely to be influenced by longer-term trends as well. Without intervention, more than a half-century of spectacular, global economic development may remain a mere curiosity in economic history. The world's economists and economic policy-makers can rise to these challenges only by determination, long-range planning and concerted efforts.