



Economic Crisis or Global Malaise in 2006?

JOSEPH E. STIGLITZ

The almighty American consumer had another banner year in 2005, helping sustain global economic growth, albeit at a slower pace than in 2004. As in recent years, he consumed at or above his income level, and the United States as a whole spent well beyond its means, borrowing from the rest of the world at a feverish pace in 2005 – more than \$2 billion a day.

A year ago, most pundits argued that this was unsustainable. It evidently *was* sustainable,

Joseph Stiglitz, recipient of the 2001 Nobel Prize for Economics, is University Professor at Columbia University. He served as the Chairman of the President's Council of Economic Advisers during the Clinton Administration. He was also the Chief Economist and Vice President for Development of the World Bank. He has authored hundreds of academic articles as well as Globalization and its Discontents, and The Roaring Nineties.

at least for one more year. But it nonetheless remains true that whatever is unsustainable will not be sustained in the long run, which creates great risks for the US and global economy in 2006.

Two economic surprises prolonged the good times in 2005. First, while the US Federal Reserve continued hiking short-term interest rates, long-term rates did not increase in tandem, which allowed housing prices to continue rising. This was centrally important to sustaining global growth, for the performance of the world's largest economy has been fueled by real estate in recent years, with individuals refinancing their mortgages and spending some of the proceeds, and with high prices leading to more construction.

But this is unlikely to continue. Long-term interest rates almost certainly will *eventually* start to rise – and “eventually” increasingly looks like next year. If so, Americans will have to spend more money on debt service, leaving them with less to spend on consumption of goods and services. Moreover, real estate prices will most likely stop rising rapidly – indeed, they may even decline. As a result, refinancing of mortgages will grind to a halt, leaving no money to draw out of housing to sustain Americans' consumption binge. On both accounts, aggregate demand will decline.

Is it possible that the cash-rich corporate sector will more than make up for the slack by increasing investment? There may well be some increase in gross investment, as obsolete equipment and software are replaced. But there

also is some evidence that innovation is slowing – perhaps the result of reduced investment in research in the past five years.

In any case, even if firms are cash-rich, they do not typically expand investment during periods when consumption is slowing. Uncertainties about the economy are likely to insert an element of caution into companies' investment decisions. In short, it is more likely that moderating investment will exacerbate the consumer slowdown than that an acceleration of investment will offset it.

But this is not the only reason for bleaker prospects for America and the world in 2006. The second surprise in 2005 was that while oil prices increased far more than expected, the economic dampening effect seemed somewhat muted in most places, at least until the last part of the year. Because of higher oil prices, for example, America's spending on oil imports has increased by roughly \$50 billion a year – money that otherwise would have been spent mostly on goods made in America.

For most of 2005, Americans behaved as if

they didn't really believe that oil prices would remain high, at least for a while. This is less startling than it may appear: econometric studies suggest that it takes a year to two before the full effects of oil-price increases are felt. Now, with futures markets predicting that oil will be \$50 to \$60 a barrel for the next two years, demand for gas-guzzlers has evaporated, taking with it the prospects for America's auto companies, whose corporate strategies have bet on low oil prices and America's love affair with the SUV.

High oil prices are set to dampen economic performance in the rest of the world as well, although growth prospects look better than in the US. China's growth continues to astound the world; indeed, new GDP data suggest that its economy is 20% larger than previously thought. Moreover, China's surging growth will echo throughout much of Asia, including (in somewhat muted form) in Japan.

Europe continues to be a mixed picture, with the European Central Bank almost perversely raising interest rates even as Europe's economy needs further stimulation to ensure its recovery.

As if that were not bad enough, Germany's new government is promising to raise taxes. Fiscal rectitude in the right place and the right time is to be commended; but this is the wrong place and the wrong time – and Germany's recovery prospects will be dampened.

The main risk in 2006 is that America's long-brewing problems come to a head globally: investors, finally taking heed of the large structural fiscal deficit, the yawning trade gap, and the high level of household indebtedness, may pull money out of the US in a panic. Alternatively, rising interest rates and a downturn in the real estate market could so weaken consumer demand that the economy slips into recession, squeezing exporters in other countries that depend on the US market.

In either case, the US government, hamstrung by already-wide deficits, may feel powerless to respond with countercyclical fiscal policy. With confidence in Bush's economic management almost as low as confidence in his management of the Iraq war, there is every reason to worry that should one of these crises emerge, it will not be well managed.

But it is more likely that 2006 will just be another year of malaise: China's significance within the global economy is still not large enough to offset weaknesses in the rest of the world. America, too, will manage to muddle through again – leaving even higher levels of debt for the future.

In short, 2006 will be marked by mounting uncertainty about prospects for global economic growth, even as the distribution of the fruits of that growth remain dismally predictable. In America, at least, 2006 is likely to be another year in which stagnant real wages freeze, or even erode, the living standards of those in the middle. And, everywhere, it is likely to be another year in which the gap between the haves and the have-nots will widen.

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ACKNOWLEDGMENTS

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