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America's 8-Cylinder Economy Running on 5

By Michael Spence

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In the dog days of summer, Milan is quieter than many European cities. The locals are away, and, unlike Paris or Rome, tourists do not take their place. Here and elsewhere, people, businesses, governments and markets take a break, decompress and reflect. Europe's economic problems will still be here, waiting for us, in September.

When summer ends, uncertainty about key issues will be the order of the day — and not only in Europe. Largely unanticipated protest movements in Turkey and Brazil have raised questions about the economic and social sustainability of emerging-market growth. The fires in Bangladeshi garment factories have raised new questions about the governance of global supply chains.

In the U.S., the Federal Reserve hinted at "tapering" its quantitative-easing policy later in the year, and a kind of global carry trade based on monetary conditions in advanced countries started to unwind as a result, causing credit tightening and market turbulence in emerging economies. This is probably only a preview of the complexity of the exit from the post-crisis, assisted-growth model that has prevailed in the U.S., Europe and now Japan. A possible political impasse in the U.S. in September over the budget and debt ceiling complicates the outlook further.

And yet much of the current uncertainty is set to dissipate. In the coming months, highly consequential policy decisions (or their absence) in systemically critical parts of the global economy will be revealed with significant effects on growth rates, asset prices and overall confidence.

For starters, China's new leadership has moved away from outsize fiscal and monetary stimulus and accepted an economic slowdown, betting on structural change, systemic reform and sustainable longer-term growth. The key signals will come from the Chinese Communist Party's plenary meeting in early fall.

China's reforms will either support the economic shift, boosting sentiment and lifting growth forecasts, or they will fall short and disappoint, with attention most likely to be focused on the size and nature of state intervention in markets. Either way, with the future of the global economy's principal growth engine at stake, the effects will be felt worldwide.

In the U.S., economic deleveraging has proceeded significantly further than it has in Europe. The U.S. is adjusting structurally and generating real, inflation-adjusted growth in gross domestic product, although it is well below its potential annual rate of 3 percent or 3.5 percent. The tradable sector is expanding and is not dependent on leverage to generate aggregate demand.

One can think of the U.S. economy as an eight-cylinder engine running on five, owing to residual deleveraging, fiscal consolidation, drag, public-sector investment shortfalls and questions about the financial health and security of middle-income households, the backbone of domestic aggregate demand. Part-time employment is spreading and may become the labor market's new normal.

Then there is the question of the Federal Reserve's assisted-growth model. Is the U.S. economy ready to grow without abnormal policy support? It seems clear that tapering the Federal Reserve's monthly purchases of long-term securities later this year would cause a realignment of asset values in financial markets. How this spills over into the real economy is yet another source of uncertainty.

But despite some transitional market turbulence, the overall effect will likely be positive. The beneficial effect on the risk-return options available to investors and savers, including pension funds, will outweigh the higher cost of debt. Indeed, an important subset of growth engines in the tradable sector is not dependent on low-cost debt.

The same cannot be said of Europe, where Germany's general election in September is viewed as a key barometer of continuing commitment to the euro. The European Central Bank's "outright monetary transactions" program — though conditional, limited to short-term government debt and so far unused — appears to have stabilized eurozone sovereign-debt markets, albeit in a low- or zero-growth environment. But the outright monetary transactions program is dependent on German support. The question is how long this can last, given southern Europe's growth and employment challenges and an apparent lack of understanding among policymakers and the public that there are no short-term solutions.

In Italy, the debate centers on taxes in general and the rather minuscule property tax in particular. The income tax and the tax on employment is high. But the country is relatively wealthy, especially in terms of property assets on household balance sheets. So higher taxes on property and lower taxes on income would contribute to the creation of a more dynamic, competitive economy.

But that is far from the current focus of public debate. The key liberalizing reforms that would enhance the economy's flexibility and pace of adjustment are simply not on the agenda owing to an underlying lack of trust among voters.

This is important because the private sector in Italy and in Spain cannot match the structural flexibility found in the U.S. and in Germany since its reforms in 2003-06. Think now of an eight-cylinder engine running not on five cylinders, but on two or three at best. Admittedly, the Spanish labor market reforms enacted earlier this year may start to lift employment and improve competitiveness and growth on the economy's tradable side, which is constrained largely by low productivity, not weak demand.

But the default option in the context of political gridlock — a halting, slow-growth strategy, focused excessively on fiscal austerity and featuring high unemployment, especially for the young — is unlikely to remain workable for long. At some point, the political agenda will either shift toward real reform or sentiment will shift substantially against the euro.

Fortunately, this uncomfortable uncertainty will not last much longer in Europe or elsewhere. China's leaders will make their choices, as will German voters. The Federal Reserve will clarify the direction of U.S. monetary policy. Markets will adjust and settle down, and distortions will begin to unwind.

Without dismissing the downside risks, I remain cautiously optimistic about growth prospects for the global economy. With greater clarity in terms of Chinese and U.S. policy, both economies should gain momentum. That will give developing countries, many of which face difficult domestic policy choices, a tailwind, while making the substantial challenges in Europe and Japan easier to address.

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