Towards a Post-Crisis Global Economy:

Long-Term Growth Scenarios and the Impact on Exit Strategies

Vanessa Rossi and Rodrigo Delgado Aguilera

International Economics, Chatham House

September 2009
**Key Points**

- One year on from the onset of the global crisis, as policymakers turn from firefighting to considering the next steps for recovery, a key question is whether there has been a severe but temporary setback to economic growth or a permanent adjustment in long-run projections. Could this crisis and the cost in terms of public finances haunt the world economy for many years to come?

- Many analysts would agree that, compared with pre-crisis assessments for the GDP outlook, this recession will cast a long shadow over prospects for the economies most involved, chiefly the US and Europe. But should this shadow extend over the 10–20-year view and beyond? The short-term shock is unlikely to change demographics, but arguably it will encourage more cautious reappraisals of the other determinant of long run growth, future productivity trends.

- Long-term GDP projections are indeed under review but proposed changes should not go unchallenged as they are highly debatable, politically sensitive and critical to the short- to medium-term outlook. Firstly, given the intrinsic difficulties in forecasting productivity (GDP/head), all projections are tenuous and reflect factors other than economic opinion, such as forecast credibility, business confidence and political leanings. Secondly, GDP projections will be critical in policy-setting, including planning the timing and scale of exit strategies such as the normalization of monetary and fiscal policy.

- Estimates for future GDP, public-sector deficits and debt are particularly important for the Euro area given that currently high government deficits are pushing up average debt to 70-80% of GDP, well above the debt target of 60%. Adjustments required to bring debt down will be even tougher if GDP growth is low.

- Given the important influence that long-run GDP assumptions have on policy and thus on the short-run economic outlook, they need to be scrutinized carefully. And policy decisions should take into account the highly uncertain nature of such estimates, adopting a flexible approach to target setting to allow for the possibility of further adjustments based on new information.
Introduction

As part of the autumn round of forecasting and policy recommendations, analysts are taking stock of the new post-crisis reality and reassessing economic prospects for 2010 and beyond, including revisions to projections of long-term growth potential, the outlook for public-sector finances and probable adjustments in monetary policy. Two interlinked issues are therefore high on the economic policy agenda:

- post-crisis reassessments of long-run economic forecasts and their implications for projected GDP, monetary policy setting, projections of public-sector budgets and debt/GDP ratios, in particular comparing these to pre-crisis forecasts and policy targets, such as those applied in the EU;

- the need to prepare so-called ‘exit strategies’, to reverse fiscal spending and interest rate policies together with all the panoply of extraordinary policy measures that have been introduced over 2008–09, and to consider the appropriate timing for initiating such strategies in view of the potential impact that premature tightening may have on markets and the nascent economic recovery.

Although this is mainly a US-EU issue, much of the discussion in G20-related meetings is likely to reflect the increasing preoccupation with the second point: exit strategies. Disputes look inevitable over timing and coordination, with the Euro area (especially Germany) seemingly determined to press ahead with setting a timetable, in particular to ensure that sound fiscal discipline is restored promptly. Other countries (led by the US and UK) see this step as very premature or even unnecessary as allowing economies to return to robust growth could help reduce the temporary burden created by the recession.

In light of these talks, markets will watch for signs that interest rates could begin to rise from the current near-zero policy stance or that policy-makers may be preparing to step hard on the fiscal policy brakes. Governments, in turn, will watch market reactions to assess the implications of a change in direction – for example, the Euro area is probably not keen on the
strengthening of the euro against the dollar so as to avoid new turmoil in markets, not least because this would disrupt the hoped for exits of central banks and governments from direct intervention in markets and business. Governments want buoyant markets as they are looking to raise funds by selling off stakes in companies (chiefly banks) acquired during the crisis and are also keen to see rapid repayment of bailout money. In fact, some governments have already been quick to recoup funds as global stock markets have rallied and banks have returned to profit – with taxpayers benefiting from returns on their crisis-driven investments.

But the first point, which tends to slip past as a technical assumption, should not be ignored. Revised long-run GDP projections will have a critical bearing on actual policy actions and outcomes for the global economy over the next few years as well as playing an important role in shaping the global economy of the future, as they impact on long-run investments for both physical and human capital. There should be an active debate about just how sound such forecasts are and the inherent risks in the planning methodology, which may lead to over-reactions, stifling of the recovery and poor long-term development of the capital stock. Even more troublingly, official projections for long-run growth can become self-fulfilling prophecies once they are adopted as the basis for tough policy-setting that automatically crimps growth.

What changes in are likely? Forecasts for developing countries remain buoyant, undimmed except for a temporary jolt during the global recession. Indeed, post-crisis reviews suggest that confidence in the long-run prospects for emerging markets may even have strengthened while views on the OECD’s outlook have become generally more pessimistic. For the US, estimates of long-run GDP are tending to be revised down slightly – in fact, this was true for new assessments just before the crisis, with estimates for both the labour force and productivity edging down. However, there is more concern over possibly substantial downward revisions in Europe, especially as the policy implications of downgrades in Euro area GDP will probably be much harsher than in the US, thus errors in judgement could have very damaging consequences for the European economy.

Yet, ignoring previous substantial forecasting errors (see Table 1 for examples), European policy-makers may now be preparing to use heavily revised long-run growth estimates as the basis for advice on policy
adjustments. Indeed, this analysis may provide support for arguments in favour of tough and rapid post-crisis policy tightening.

Table 1: Forecasting errors in official GDP estimates for the EU27

<table>
<thead>
<tr>
<th>Date of forecast</th>
<th>EU27 GDP 2008</th>
<th>EU27 GDP 2009</th>
<th>EU27 GDP 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 2007</td>
<td>2.4</td>
<td>2.4</td>
<td></td>
</tr>
<tr>
<td>Spring 2008</td>
<td>2.0</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>Autumn 2008</td>
<td>1.4</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>January 2009</td>
<td>1.0</td>
<td>-1.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Spring 2009</td>
<td>0.9</td>
<td>-4.0</td>
<td>-0.1</td>
</tr>
</tbody>
</table>


Revised estimates of long-run growth imply very large cumulative changes in GDP forecasts (as demonstrated below) and if these projections are subsequently used to guide fiscal and monetary policy decisions, the implied changes in the path of policy will also be substantial. For example, a cut in the long-run growth forecast implies even greater cuts in government net spending if the aim is to contain debt to a target share of GDP (60% under the EU’s Maastricht rules). The adjustment process itself creates downward pressure as heavy short-term budget cuts damage growth.

Also, once a recovery gets under way and the rate of growth picks up, if policy setters have adopted a lower bar for the definition of sustainable long-run growth then there would be early pressure to tighten policy to avoid the perceived threat of overshooting and overheating (e.g. rapidly raise rates, as discussed below and illustrated in Figure 6). However, if the estimate for long-run growth is unjustifiably revised down, such policy reactions would be excessively draconian. There is a danger of actual GDP growth being capped to meet an erroneous assessment of the safe ‘speed limit’ – the equivalent of driving at just 30mph on the motorway as a result of misreading the sign.

As the true limit to GDP growth is not observable, estimation errors may not be easily corrected unless other signs of the error, such as high unemployment, are taken into account as well. Therefore, while assessments of long-range growth prospects are essential for many planning purposes, given the poor reliability of forecasts it would seem unwise to base policy
decisions too heavily on any one scenario or shift in opinion – allowing policy to be nimble and flexible in the light of unfolding events, rather than being over-reactive to long-range estimates, may be the most appropriate stance. Strongly committing to large policy changes on the back of potentially misleading (and clearly uncertain) volatility in projections is not advisable.

**The Impact of Different Types of Recovery on Long-run Forecasts: the Example of the Euro Area**

Although hopes of recovery are rising, expectations regarding the scope of this recovery are extremely cautious. Recent forecasts point not only to a sharp drop in GDP in 2009 but also to the persistence of low growth over the medium term (Figure 1). This implies a very slow return to the previous peak for GDP over the next 2–3 years and continued divergence from pre-crisis estimates for the level of long-run GDP – so that, in this sense, the economy never fully recovers (see for example Figures 2 and 3, scenario C for the Euro area).

For Europe, this pessimistic view reflects negative reassessments of the outlook for European industries, investment and jobs. It effectively assumes an accelerated withdrawal from some industries, in particular in the highest-cost Euro states. Moreover, although restructuring and the loss of basic industries should raise productivity for the remaining workforce, productivity assumptions for the future tend to be lower, not higher – a double blow.

Long-run growth forecasts for the US are also being downgraded in view of the overhang of economic problems and costs of the crisis. But new estimates of trend growth look set to remain higher (2–2.5% per annum) than for the Euro area (1-1.5% p.a.). Admittedly, this is partly because of higher projected population growth, however, the complex issue of impacts on long-run productivity growth also arises for the US, which so far remains the technological leader of the world economy. Might the crisis topple the US from this position? Will another country take over this leadership role or might the global economy have run out of new drivers for technological progress and new inventions? These questions and alternative scenarios for productivity projections will be examined more specifically in a forthcoming Chatham House briefing on what drives long-run productivity.
Relatively pessimistic projections for Europe certainly contrast with more optimistic expectations in emerging markets, where a full recovery is expected to put GDP back on track (equivalent to scenario A in Figure 2, which is similar in shape to the recovery actually achieved in most of Asia after the crisis in the late 1990s). The still large scope for productivity in the developing world to be boosted by straightforward catch-up growth implies that the issue of leading-edge productivity gains and technology breakthroughs is of little import there, whereas it is critical for growth in the leading OECD economies.

However, simply comparing post-crisis and pre-crisis projections of long-run GDP and productivity, the key judgment about whether or not to change these projections turns on the interpretation of the 2009 crash: is this essentially only a temporary - albeit very large - cyclical shock from which economies can fully, if slowly, recover (the developing world’s view)? Or might this recession require the pre-crisis analysis of long-run GDP and productivity trends to be significantly modified (the European view)?

**Figure 2: Alternative scenarios for Euro area recovery**
As Figures 2 and 3 make clear, growth needs to rise temporarily above the previously estimated trend to enable the economy to catch up with pre-crisis projections for GDP levels (scenario A). This best-case scenario, in which the economy completely makes up lost ground, was examined in a recent Conference Board study (Van Ark, 2009), which determined that growth of nearly 4% in the US and 3% in Europe would be necessary to close the output gap caused by the recession by 2015. But even if economies begin to
recover in 2010, with growth rates returning to the previous trend, a one-off loss of around 5% in GDP will persist (scenario B). This seems to be the scenario considered most likely by European policymakers but also increasingly by the Bank of England which has recently stated that the current level of output is 8% lower than it would be compared to the pre-crisis trend.\(^1\) The implication, therefore, is that even if growth rates return to normal, the fall in output levels may be permanent.

However, if growth rates are also revised down, cumulative losses will grow over time, perhaps to as much as 20–25% compared to the full recovery scenario by 2020. This loss is depicted in Figure 3: projected GDP not only fails to close the gap opened up by the crisis but the gap widens over time in the case of lower long-run growth (worst-case scenario C). This scenario was illustrated in a recent European Commission (EC) report which warned of the possibility not only of a permanent downward shift in Europe’s potential output level but also of a reduction in potential output growth.\(^2\) It cited factors such as the increasing burden of government debt – owing to the crisis, debt-to-GDP ratios may rise throughout the OECD by around 20% or more (see IMF, 2009) – and inflationary pressures linked to monetary expansion. However, these explanations need to be rigorously examined and tested. As noted above, this is important because politicizing the debate over long-run growth and potential output may have consequences for the implementation and scale of exit strategies.

A combination of tough exit strategies coupled with low growth prospects has important implications for EU budgets, for financial markets and, given the international repercussions, for trade partners, which could sour international relations. Any significant downgrading of long-run growth estimates, compared with relatively recent assessments, is therefore of concern for many reasons, including the potential policy consequences. Low growth also means that unemployment will almost certainly rise even more than most current projections suggest and remain high (as illustrated by the stylized scenario examples for employment and unemployment in Figures 4 and 5).

---

\(^1\) Financial Times (2009), “King keeps focus on output gap”, 15 September 2009
\(^2\) European Commission (2009), pp. 36-38
Monetary and Fiscal Consequences of Lower Potential Output

We can easily demonstrate the consequences of alternative assumptions regarding forecasts for GDP and growth potential. For example, if either scenario B or C were to emerge, why would there be no attempt to restore GDP in line with scenario A? If this underperformance is interpreted as an emerging output gap, reflecting deficient demand in a downturn, monetary
policy should remain stimulative until the gap is closed. This is more or less the US view of the recession problem.

However, if policy-makers believed there to be little or no output gap, because the economy’s maximum potential performance had fallen (to scenario B or C), they might be more inclined to adopt a restrictive policy stance. Indeed, even if policy rules take no account of output gaps per se, the view that the non-inflationary growth rate might be lower than previously estimated would also encourage more cautious policy tightening due to fear of inflationary pressure. There would certainly be no reason to consider further stimulus because the economy would already be operating at its maximum long-run growth rate (full capacity) according to the new, lower estimates for growth potential. Eventually this would create a self-fulfilling prophecy as temporary unemployment and spare capacity would turn into permanently embedded losses. This is the dilemma that appears to be facing Europe and is illustrated in Figure 6.

Figure 6: Monetary policy tightening under lower potential output levels

Fiscal policy is also influenced by estimates of long-run growth as prudent public-sector debt management tends to be measured in terms of debt-to-GDP and deficit-to-GDP ratios. Reduced estimates for long-run GDP lead to cuts in net government spending in order to bring public-sector deficits and
debt in line with the lower GDP profile, thereby meeting the target ratios set for budgets and debt-to-GDP ratios. Given the EU’s strict approach to budget management, normally requiring deficits to be below 3% of GDP, there are already ‘excessive deficit’ proceedings under way for a number of member states (Ireland, Greece, Spain, France and the UK), with a deadline of 27 October for presentation of adjustment plans for the next 3–4 years. In this case, one form of exit strategy is already being imposed by the EU – and it will be severely affected by the changes in forecasts made since these proceedings were first assessed (for example the UK’s 2009 deficit is now expected to be in the range of 10–15% of GDP, well above pre-crisis estimates of around -3%).

The other critical ratio that is monitored is debt-to-GDP. Under the influence of the recession this is rising rapidly; estimates suggest that the Euro area average will reach over 80% in the next couple if years, well above the 60% reference limit that prevailed in 2007 (Figure 7). Bringing the debt-to-GDP ratio back to around 60% will also require a severe adjustment plan, implying much tougher budget deficit targets (well below the 3% ceiling) for a decade or more.

Unfortunately, most analyses of long-run debt targets tend to focus mechanically on the annual budget balances needed to reach target debt ratios, say by 2030, on the basis of long-range forecasts. This ignores the fact that any deterioration in underlying projections for GDP over this period will imply an even more significant trimming down of debt to achieve the same target ratio, with yet further feedback effects on GDP in consequence. For example, as shown in Figure 7, if the average rate of Euro area GDP growth were to drop to 1% per annum, meeting a target ratio of 60% of GDP would require a reduction in debt by 2030 of at least $2 trillion compared with the debt level under a 2% growth rate scenario. In other words, the required fiscal balances will necessarily be even higher under the 1% growth scenario than under the 2% scenario in order to achieve the same debt-to-GDP target rate.

---

1 Legal decisions adopted by the Council on 27 April 2009.
2 The European Commission’s Spring Forecast (May 2009) estimated a debt-to-GDP of 83.8% for the Euro area in 2010.
Figure 7: Euro area debt under lower potential output growth scenarios

Note: Estimates assume an average inflation rate of 1.75% between 2015 and 2030.

Source: Own estimates from IMF data.

Whether governments would be able to pursue such draconian cuts in budgets is open to question, given that such a prolonged fiscal squeeze might not be politically sustainable. This political uncertainty might encourage financial conservatives to press even harder for very rapid fiscal consolidation – an extremely harsh measure, especially if the estimates of long-run GDP and debt were inaccurate. Economic performance might be sacrificed to political expediency.

Conclusion

Clearly it is dangerous to allow tough policy choices to be based on highly uncertain, and possibly seriously flawed, estimates of a variable that, by its very nature, can never be known for certain. We only ever observe the final outcome for actual GDP – and the fact that this may match the previously estimated long-range forecasts is only proof that policy was successful in meeting the estimates, not that the estimates themselves were right. Using the motorway analogy, you may congratulate yourself on achieving your target of 30 mph if you believe this to be the speed limit, but if the limit was actually 50 mph then a lot of time may have been lost along the way. Or, in the economy’s case, a lot of jobs.
The consequences of these mistakes are not negligible. Estimates are both necessary as a basis for decisions but are inevitably subject to uncertainty, thus requiring that policy be light and flexible rather than heavy-handed and rigid, allowing ample room for manoeuvre as new evidence emerges. To paraphrase Keynes, if the facts appear to differ from previous assumptions, then it is probably a good idea to gradually modify views and policies accordingly and to be alert and open to further changes in circumstances. To return to our analogy: if everyone else on the road is overtaking you, then it’s likely you have misread the speed limit. It is far better to have an adjustable speed control rather than one which has been locked for the next few hundred miles.

References


European Commission (2009), Quarterly Report on the Euro Area, 8 (2).


OECD (2009), OECD Economic Outlook 85, June 2009, Chapter 4, pp. 221–41.
