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France and the US facing global economic challenges

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When we met for the first time in Paris, last December, the world economy was at the peak of the crisis. Following the financial meltdown accelerated by the bankruptcy of Lehman Brothers, macroeconomic indicators shrank at a pace not seen since the Great Depression. Trade, investment, employment were decreasing dramatically not only on a year to year basis but on a month to month basis. The questions was then mainly to find quick fixes for the economy through monetary and fiscal stimuli and to ensure cooperation between governments to make sure that credit, trade and investment were kept alive. At the same time, it was important to put on the table lasting solutions for financial markets regulation in order to restore confidence of economic agents.

That is the reason why in the first conference I had chosen to emphasize the ways through which those solutions could be reached and how France and the US could cooperate in that direction.

Obviously a lot of work has been done since December. The new American administration as well as other governments and central banks have pushed stimulus and bank safeguard measures further. New means were given to the IMF to assist troubled public finances. Financial markets regulation has also been high on the agenda. Finally, governments repeated their opposition to protectionist measures and adopted measures to facilitate credit to exports. The meeting of the G20 in April embodied this effort. It has been a long effort, it has been sometimes messy, more effort is still needed – especially in Europe – but the main element is there: economic policy has been much more reactive than at the beginning of the Great Depression. And CNN now has a new slogan: the road to recovery.

Today, I would like to insist on the risks as well as the likely twists and turns of economic policy in the coming years. I have listed for main challenge for both France and the US.

Challenge 1: a social challenge

The first challenge is directly related to the lives of millions of workers around the world. Unemployment has been rapidly rising and is expected to keep rising in future months. It is expected that it will exceed 10 percent in both France and the US at the end of 2009.

The challenge is to give hope to those people losing their jobs who know they will have a hard time finding a new one and will face financial difficulties with lots of side consequences. France is a little better prepared in the sense that it has a generous social protection system. But it is confronted to very long duration of unemployment (one year on average) and to the risk of exclusion of the unemployed as they lose their employability. I would argue that the challenge for France is to start a very big effort to improve training for the unemployed so that the time people are unemployed is not lost and employability is preserved. The French government should also pursue further reforms in the service sector, in order to reduce barriers to entry for such regulated jobs as notaries, taxi drivers and train more plumber instead of blaming Pole plumbers.

In the US, the challenge is high as a better insurance system needs to be created. Losing a job in the US has even more consequences than in France given the price of healthcare or children's education for instance. This will be one of the tasks of the new president: finding a way to give better temporary assistance to the unemployed.

However it is obvious that financing this effort will put pressure on public finance as well, especially given the pressure already exerted by an aging population on the pension system. This calls for increased efficiency of public spending and an effort at increasing the sustainability of social insurance systems. This needs to be explained with clarity to citizens. They deserve help but also transparency on the efforts that will be needed.

Challenge 2: Inflation and debt

One of the biggest challenges ahead is what is going to happen with debt and money supply. So far public debt has been substituted to private debt, which had reached extremely high levels in numerous countries. So public debt will be a first problem. How do we handle it? With inflation or with restrictive fiscal policies? Of course restrictive fiscal policies are not attractive to politicians as they have a recessive effect on the economy. On the other hand, it has been successfully implemented in some cases in the past, for instance in Sweden in the 1990s. Inflation on the other hand has been much criticized in the past. The risk of uncontrolled inflation is indeed that it creates a price spiral that will eventually hurt economic activity and lead to high interest rates with both an explosive effect on public debt and a recessive effect on the private sector. The temptation to use inflation is that it is a hidden tax that would allow a quick reduction in public debt in the short term and might be efficient as long as it remains temporary. However it is a tricky game and it will require important dialogue and coordination between governments and central banks as diverging policies could lead to major adjustments in exchange rates patterns.

Another aspect of the problem is the amount of money that is now circulating. In order to support credit, money supply has been increased enormously by central banks. As

Jean-Claude Trichet puts it, money is like toothpaste. When it is out of the tube, you cannot have it go back in it. So when anticipations start to improve and money velocity start to increase, there is a risk of overheating with some form of inflation or another. It could be either a new housing or financial bubble, or inflation of good prices (food and energy especially as supply is constrained). There are two ways of looking at it. The first is to think of it as a new inflation surprise as I think happened in the 1990s. Some said that those years were years of growth without inflation but I really think it was not. It was a period of growth with asset price inflation. So the other way of looking at the issue is to say that we might have a new crisis in the future, even larger than the one we have seen in recent months. More of the same, so to speak. I do not think it is a good solution of course but in the short run a new inflation surprise is attractive for politicians.

Challenge 3: trade wars and global imbalances

The crisis has not solved global imbalances. The current account balance of China remains largely positive for instance while the US current account balance is negative. As economists have long explained even before the crisis, this is not sustainable. This imbalance has been supported by excessive indebtedness in the US and artificial support to exports in China. Today, we see other worrying trends with the yen appreciating massively and supporting the same pressures than the euro supported in recent years when it appreciated against foreign currencies. When the crisis is over, the euro might again appreciate severely against the dollar if central banks have different policies in front of inflation.

High risks are associated with such imbalances: to limit the domestic costs of it, some countries might be tempted to organize the depreciation of their currency like Switzerland already did. If other countries adopt such strategy, this could initiate a form of protectionism or trade war through exchange rates interventions. Why would this be an issue? Because it will distort trade and place a heavy burden on countries refusing to enter the game. Also it will encourage very accommodating monetary policy in a time when, as we have seen, it will be necessary to reduce the supply of money in order to avoid a new inflation-debt cycle.

In order to limit such an uncooperative game, it will be necessary to organize central banks and government cooperation on the road to recovery. The IMF should also be given a role in this respect. On the other hand, Western countries, especially France and the US, should encourage China in its effort to support consumption and build a social system for its population. Increasing Chinese domestic demand is indeed a first step towards reducing global imbalances. China should also be encouraged to move towards a more flexible exchange rate policy, for instance by linking the Yuan not to the dollar only but to a basket of several foreign currencies. This would be a better solution compared to its desire to have a new international reserve currency replacing the dollar.

Challenge 4: Back to scarcity

One of the effects of the crisis has been to hide temporarily the energy, food and environmental crises. There are however reasons to believe that energy prices will be back at high levels as soon as the economy recovers. First, because of the time lag necessary to production capacity adjustments or to a significant increase in new sources of energy. Second, because it is unlikely that geopolitical tensions will disappear any time soon. Concurrently, the environmental challenge has yet to be fully addressed: all measures show that climate change or the increase in water scarcity are actually faster than expected. The Copenhagen summit at the end of the year will be a major stake in this respect. Beyond the necessary cooperation between both sides of the Atlantic to succeed in setting ambitious post Kyoto goals, it is highly important that new technologies for energy saving or renewable energy find a favorable environment in the Transatlanctic economy. This requires an effort to support together R&D efforts (for instance in 4th generation nuclear reactors, or in biomass, solar energy, capture and storage of CO_2, and next generations of biofuels) and create new common standards. It is important to explain to citizens that this is a top challenge that need to be met with first class policies, especially for countries that want to stay on the edge of technologies and that need to preserve their energetic independence, in front of countries such as Russia. We need to be conscious that the world faces a threat of returning to a Malthusian economy that would slow down the increase in living standards and encourage conflicts.

Challenge 5: the future of industry

Manufacturers all over the world are facing massive decrease in sales following the reduction of investment and exports. As a consequence, the most indebted of them and the weakest - often, unfortunately, the smaller ones – are going bankrupt. One could say that it is just a peak of a long trend, that of deindustrialization of OECD countries. However, it will have especially tough consequences on employment in some sectors. The car industry is just one of them. Governments in France and the United States have tried to address this issue by providing subsidies and loans to troubled companies. The risk, as always with industrial policy, is to pick losers and invest in declining industries. This is especially true for car companies: 90 millions cars are produced in the world every year. Sales this year will probably reach 50 million and even with the recovery it is probable that we will be back to 60-70 million cars sold, not 90. In this context, a consolidation is necessary with major adjustments needed in the US, Europe and Asia. The particular challenge of the US will be to invest in retraining the people laid off from car factories and facilitate their transition to other sectors. It will also be to help affected cities like Detroit. In Europe, one challenge will be to foster the development of newer industries, for instance in biotechs and greentechs. Some might be able to employ large amount of workers, for instance in sustainable construction. Training and retraining will also be a top priority here.

Conclusion: the new world ahead

In the post-crisis world, governments in both France and the US will face higher unemployment and public debt. They will also be confronted to a new global landscape. It is to be expected that emerging economies such as Brazil, India and China will continue to catch up. In this context, the transatlantic relationship is more than necessary, in order to provide a market large enough to generate the economies of scale and innovations required to maintain the economic leadership of Europe and the US. Cooperation will also be required to face future threats such as scarcity, global imbalances, inflation and trade wars. It is important here to understand that we need, more than a speech, a strategy and a roadmap. And this time, we have to think and act ahead.