



*Financial Times*, January 3, 2006

## **In the best of times, it's wise to ponder the worst**

By Kenneth Rogoff

Published: January 2 2006 20:29

In today's benign environment of global growth, anyone who cautions that good times might end is a heretic. What if Pharaoh had beheaded Joseph for daring to suggest higher taxes during the fat harvest years so people would not starve during the lean ones? Instead, Egypt's leader cast his lot with the world's first recorded business cycle theorist and the rest is, well, history. But are our leaders today preparing for the inevitable downside of the cycle? I wonder.

Let us first acknowledge that we are indeed living in boom times. The central scenario for 2006 is continued strong global growth. Rising global investment combined with higher demand by oil and commodity exporters should keep overall global demand growing briskly in 2006, even as US consumption and Chinese investment growth slacken. Moreover, underpinning this happy scenario are numerous positive developments.

First and foremost, of course, is the continued rise of Asia (especially China) with huge and diverse benefits for the global economy. Second, thanks to greater independence, improved policy frameworks and strong tailwinds from globalisation, central banks have been enormously successful at bringing down inflation. This is a worldwide phenomenon, reaching even into regions such as Congo and Brazil where, but a short while ago, single-digit inflation seemed like a fantasy. Third, most countries have experienced a clear trend decline in income volatility over the past 20 years, even taking into account the numerous financial crises of the past decade. Fourth, long-term interest rates are back to 1950s levels, due partly to a temporary global investment shortfall.

Low interest rates, in turn, have underpinned a worldwide housing boom. Together with reduced output - volatility, they have helped bring down risk spreads on virtually every kind of debt, not least that of emerging markets.

So, today's strong growth takes place on fertile ground. Still, are the risks to the fat years as low as most markets and policymakers now perceive them to be? It does not take a prophet to think of things that might go wrong.

The number one risk to global growth over the next few years has to be the global security situation, particularly a terrorist incident involving weapons of mass destruction. The problem is not simply the event itself, but the inevitably heavy-handed reaction to it. Imagine, for example, that nuclear material were found in a container ship headed into New York. (Perhaps, as my colleague Graham Allison has mused, it might be found wrapped in one of the multitudinous bales of marijuana smuggled into the US every day.) Even if catastrophe were forestalled, governments would almost surely start treating container shipments with the same indignity now accorded to airline passengers. The ensuing delays would wreak havoc across today's far-flung global supply chains, effectively constituting a huge tax on global trade.

Equally problematic would be a meltdown in one of the world's many hotspots, for example in the Middle East, North Korea or the Taiwan Strait. Imagine that a military standoff led to a sustained pause in shipping from greater China. A pandemic such as avian flu could cause similar problems, by interfering with the movement of individuals both within and across borders.

Markets seem to fantasise that the US Federal Reserve would simply step in in the event of a catastrophe and sharply cut interest rates as it did after September 11, 2001. But a sustained blow to the global transportation network would have far more dire economic implications than a localised disaster. Is anything being done to prepare for this risk? Perhaps, but in practice, any implementation of contingency planning is likely to be woefully ad hoc, as Hurricane Katrina illustrated.

As good as the economic fundamentals are, it is easy to find more down-to-earth vulnerabilities. Top of the list has to be global housing prices – which are not actually all that close to earth any more. With US prices up 60 per cent since 2000 and even higher price inflation in many other countries it is not hard to imagine a collapse, especially in frenzied regional markets such as California – which, after all, still has a larger economy than China's.

Speaking of China, the leadership there still faces a delicate social, economic and political balancing act to sustain the country's break-neck development pace. Even using the new, higher, estimates of the country's gross domestic product (taking into account the previously under-reported service sector), investment is still more than 35 per cent of GDP, with many projects driven by local political imperatives rather than sound economic fundamentals. Deep inequalities and social strains are epitomised by conditions in China's coal mines, where unofficial estimates top 20,000 deaths per year. A pause in China's growth would have huge global implications for commodity prices, inflation and productivity.

Then there is energy. Yes, the run-up in oil prices over the past two years seems to have had a relatively modest effect on global growth. This was actually in line with most academic assessments, which suggest that at least half the perceived damage from pre-1985 oil shocks was due to monetary policy mistakes. Still, oil has not lost its ability to sting. It is sobering to note that even during the Opec embargo of 1973, oil supply fell by less than 10 per cent. Imagine the price consequences if security problems led to a sustained slowdown in global shipping.

Lastly, the global financial system, while fundamentally a source of strength, is also a source of weakness. The explosion of unregulated hedge funds and the widespread use of derivatives such as credit default swaps pose risks that are simply impossible to calibrate until the system is stress-tested. This could come, for example, in the wake of a dollar collapse, still a considerable risk as global interest rates equalise and investors turn their attention to the US's unsustainable trade deficit.

In the light of these and other risks, today's policy climate seems marked by a discouraging level of political paralysis. The US is running a substantial budget deficit in spite of a booming economy. In Europe, reforms are at a standstill. Asia needs more flexible exchange rates to share the burden of global imbalances and, in Latin America, reform paralysis in major countries has produced tepid growth in spite of a phenomenally supportive global backdrop. The common-sense biblical wisdom of using good times to prepare for worse ones does not seem to have many adherents these days. Perhaps that complacency is the greatest risk of all.

The writer is professor of economics at Harvard University and former chief economist at the International Monetary Fund