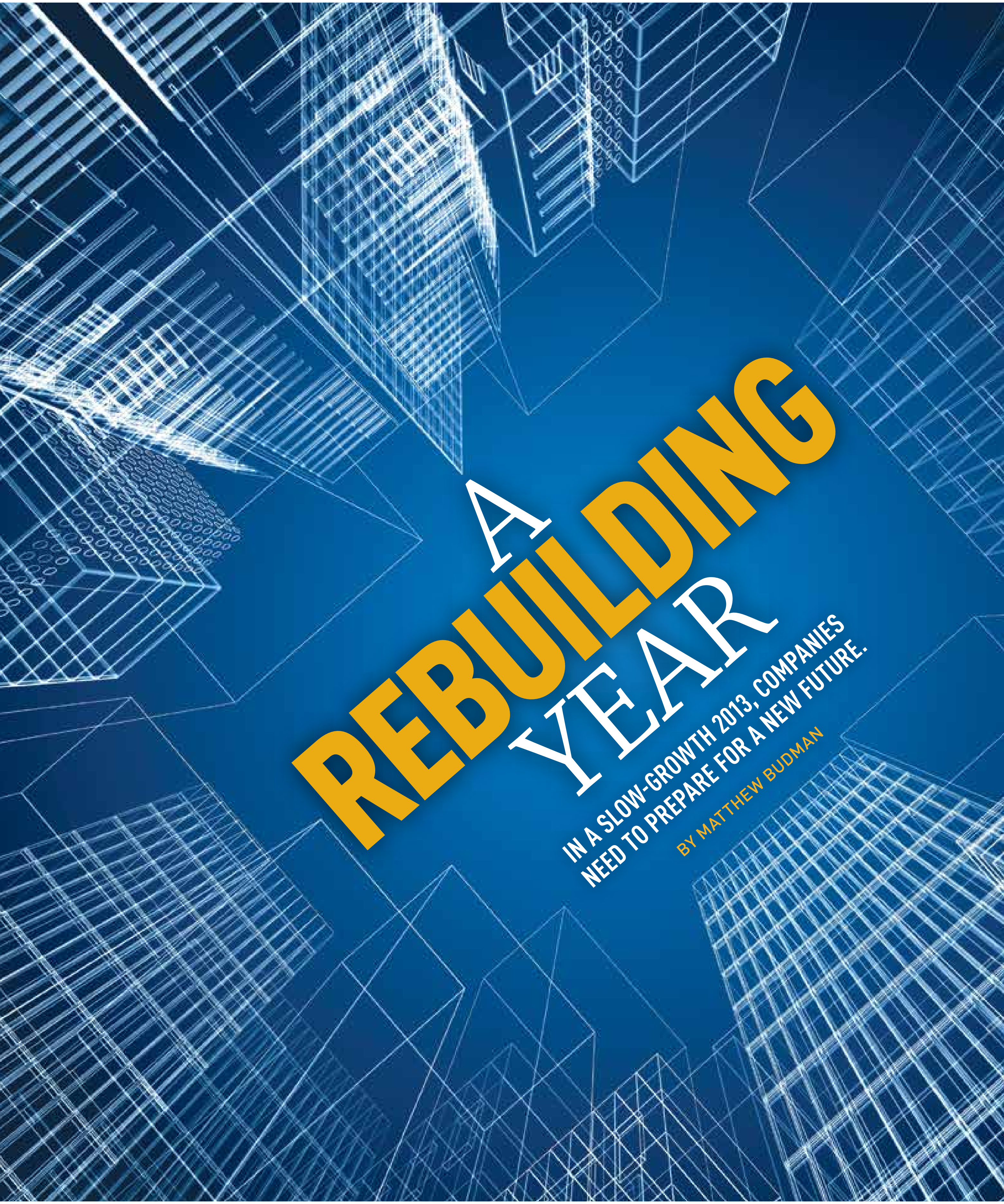

A REBUILDING YEAR

IN A SLOW-GROWTH 2013, COMPANIES NEED TO PREPARE FOR A NEW FUTURE.

BY MATTHEW BUDMAN

MATTHEW BUDMAN is editor-in-chief of *TCB Review*.

BART VAN ARK, CHIEF ECONOMIST OF THE CONFERENCE BOARD, WOULD LOVE TO BE OPTIMISTIC ABOUT THE DIRECTION OF THE GLOBAL ECONOMY. BUT HE'D RATHER BE RIGHT. WHEN HE LOOKS AT EUROPE (RECESSION-WEARY AND FACING POTENTIAL SHOCKS TO COME), CHINA, INDIA, AND BRAZIL (DRAMATICALLY SLOWING), AND THE UNITED STATES (STILL IN POLITICAL STALEMATE), HE SEES A WORLD HAVING TROUBLE GETTING BACK ON TRACK.

That's not to say that van Ark is urging CEOs to remain cautious and conservative when it comes to investment and expansion—emerging economies' maturation in particular provides real opportunities for companies looking to offer a wider range of goods and services. A slow-growth economy truly can have an upside.

JUST HOW GLOOMY IS YOUR FORECAST FOR 2013?

Compared to some of the other major forecasts and projections out there, we are somewhat downbeat. We are looking at a slightly slower 2013 than 2012, mainly because we don't see much recovery in the United States and certainly not in Europe or Japan. But where we differ from other forecasters most is that we do not see the emerging economies recovering the growth rate they had a couple of years ago.

Looking further out to the end of the decade and beyond, we see a slower growth rate in the global economy, related to factors like demographics and the maturation of the emerging economies. That is easily interpreted as bad news, but slower growth has its positive sides too. Rather than aiming for double-digit growth rates, there may be more room for the creation of value as middle classes mature and demand a wider variety of products and services. When we prepare for that, many companies will experience a positive side to this.

IN YOUR PUBLISHED 2013 FORECAST, YOU CITE A WIDE RANGE OF ISSUES: THE CONSUMPTION DEFICIT IN CHINA, THE SAVINGS DEFICIT IN THE UNITED STATES, THE GROWTH DEFICIT IN EUROPE AND JAPAN, THE UNFULFILLED GROWTH POTENTIAL OF INDIA AND BRAZIL. ARE THESE PRIMARILY PROBLEMS THAT EACH REGION NEEDS TO ADDRESS INDEPENDENTLY, OR ARE THERE STEPS THEY SHOULD BE TAKING TO WORK TOGETHER?

The world economy is completely connected, so there is definitely a need for global coordination. But that is a problem at the moment. The World Bank and the IMF are struggling to find a new model to be effective in a world in which emerging markets are making up 50 percent or more of global output, and the World Trade Organization needs to take on intellectual-property issues in a bigger way than they do now. Simple trade rules don't work anymore. With deeply integrated global value chains today, you are simply shooting yourself in the foot if you try to protect yourself at the cost of others. But often, in a down economy, political sentiment leans toward protectionism, so it is an uphill battle.

Having said all that, the world is not flat either. Individual governments need to do the hard work of structural reforms in key markets: financial, housing, energy, labor. In the run-up to a structural crisis, these markets become unstable as demand and supply grow out of sync. And so far, many of the reforms are not going very well. Reforms in financial markets don't seem to be getting at the heart of the problem, which is to help capital flow to those areas of the economy where it can be most productively used. Too much capital is sitting on the balance sheets of large companies that are not using it, while banks are putting up stringent conditions when lending to small and medium-sized businesses or to new entrants into the housing market. There should be a higher sense of urgency around these reforms.

SO YOU NOW CHARACTERIZE THE GLOBAL ECONOMY AS BEING IN A STRUCTURAL CRISIS?

I think everyone agrees that the 2008-09 crisis was not a normal recession. The most visible structural issues resulted from the huge imbalances in some of these markets, especially the housing market and the financial market. But problems were also becoming evident in other markets. In the labor market, our educational system is failing to churn out the human capital that companies need to invest to satisfy their demand for high skills. And in the energy market, in a global economy that's still largely dependent on oil, our production and needs are unsustainable; even with more supply coming from recent discoveries like shale gas, as we are cutting nuclear and struggle to get more supply of renewable energy, we need to use energy more efficiently.

All these structural problems came together in this crisis, and we need to work ourselves through the needed reforms. And that takes time—five to ten years is very normal, meaning that we may be only halfway toward getting out of this hole.

> “I think everyone agrees that the 2008-09 crisis **was not a normal recession**.

WHAT STRIKES ME ABOUT THE PHRASE *STRUCTURAL* CRISIS IS THAT FOR THE LAST FEW YEARS WE'VE BEEN HEARING ABOUT STRUCTURAL UNEMPLOYMENT, A PHRASE OFTEN INVOKED IN AN EFFORT TO REDEFINE UNEMPLOYMENT TO BE LESS OF AN IMMEDIATE CONCERN.

Higher structural unemployment is absolutely not an excuse to do nothing—it offers all the *more* reason to act! Structural reforms are critical to bring the demand and supply for capital back in sync.

We should also not fall into the trap of thinking that all the increase in unemployment is structural. Many argue—Paul Krugman is perhaps the most prominent voice—that this crisis is still foremost a demand problem: There was a deep recession in which consumption fell, business investment collapsed, and employers and especially governments massively shed jobs. They believe that above all else, we need to create an environment in which everybody starts to spend again.

DO YOU CONCUR?

Certainly, there is an element of truth to this argument: If you create a hole and produce less than the capacity of your economy, you want to fill the hole and get back to that capacity. I'm only skeptical about how much mileage you'll get out of another stimulus beyond the trough of recession we were in in 2009. Once you're out of the depths, as we are now, these demand-driven policies don't pay off that quickly and easily displace private investment that needs to get jump-started.

But the supply side of the economy is becoming a worry as well. Five years into a crisis, the capacity of the economy itself begins to erode; it's harder to get people who were laid off back into the labor market if they've been out for too long. Companies are just not reinvesting anymore, and worse, they are not using their technology and innovation—at least, they're not bringing products to market, and if you leave innovation too long on the shelf it becomes useless. The base from which the economy can begin to grow becomes weaker, and as a result the speed limit of the economy—what in economics lingo is called the potential growth rate—is slowing.

I KNOW YOU DON'T LIKE THE PHRASE “NEW NORMAL.” IS THAT BECAUSE IT IMPLIES COMPLACENCY?

Yes. “New normal” suggests we're settling into a new environment that we need to accept. With our 2013 outlook, we're not intending to get people to see it as the unavoidable outcome. But without a change of course, this will be the emerging trend. When the speed limit is dropping, we need to strengthen the base so that we will be in a better spot going forward. We're now looking at a global trend growth rate of maybe 3 percent; with that we're not falling off a cliff, so to speak. But the downside risk is that we drop to 2.5 percent global growth. With world population growth of just over 1 percent, that would leave us only 1.5 percent for increased living standards, and that's a little meager given the challenges of aging populations and higher demand for health care, education, and a clean and safe environment. For that, we need to get back to that 3 or 4 percent global growth rate.

So I don't want to call this normal. In fact, we had an *abnormal* situation before we got into this crisis, with a global growth rate of 5 percent during some years, which is impossible to sustain and mainly resulted from rapid catch-up in emerging economies. But I would not call 2.5 percent normal either.

IS ANY NATIONAL OR REGIONAL ECONOMY HANDLING THE RECOVERY SO WELL THAT OTHERS SHOULD EMULATE ITS EXAMPLE?

The economies with prudently regulated banking sectors, like Canada, have had an easier time working through the crisis. Germany did the right thing at the time of the recession by keeping employees on payrolls, which was expensive at the time but gave the economy a head start once the recovery began. Australia has been lucky because it's a commodity exporter and has benefited from China's rapid growth.

The key is to not get dogmatic about one instrument that works and another instrument that doesn't. You have to pull all the tools out of your toolbox and begin to work with them. And what works in one place cannot be easily copied elsewhere; every country's institutional and political settings are different. I doubt whether the United States could have easily emulated the worktime-shortening scheme that Germany implemented, but there might have been room for directly focused tax breaks for companies when protecting payrolls at least temporarily.

There are many different ways to fight this crisis, and efforts have to be balanced and reasonable—without breaking the bank. And timing is important: Some measures need to be taken immediately to avoid things getting worse; others, focused on making things work better, can come later but should not be forgotten.

SOME EUROPEAN COUNTRIES BET HEAVILY ON AUSTERITY MEASURES. WHAT LESSONS HAVE THEY LEARNED?

That depends who you talk to. Some people—call it the German camp—argue that austerity has been necessary to begin to bring budgets back into balance and to create responsible, disciplined economic policy. On the other hand, in some of the most affected countries, like Spain, if there's too much austerity you're not tackling the problem of the slowing speed limit. You need to do long-term investments, in education and innovation, and do the reforms, to make sure that the economy is regaining some of its vitality.

The overall lesson is not to overdo austerity, but even with investment there needs to be a credible perspective to lower the deficit so as to not lose the financial markets' confidence. We continue to work on models and scenarios that show that productivity growth and innovation, together with moderate and focused increases in government expenditures—and cuts elsewhere—can help to get back on track. It will take a long time, though—up to a decade.

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WHAT ABOUT THE SHORT TERM? ARE YOU FORECASTING ANY GROWTH FOR EUROPE IN 2013?

If we're lucky, we'll have some growth, mainly from recovery effects. Right now, financial stability has been created by the actions of the European Central Bank—at least their willingness to take action. But it is conditional on a banking union and on the need for countries in trouble to apply for support from the European Stability Mechanism, which is jointly run by the governments, first. Progress is slow, as there is no sense of direction in Europe. If policymakers don't figure out how to raise the speed limit in Europe—it's much lower than in the United States—and whether they want to do that together as a European Union or everybody on their own, we'll be back in trouble soon enough.

ESPECIALLY IF THERE'S AN IMMEDIATE CRISIS WITH SPAIN OR GREECE, RIGHT?

A Grexit, as they call the Greek exit option, is pretty much factored in, I think. But the uncertainty of that event is the contagion risk that it would bring back financial instability. A collapse of the Spanish economy could very easily contaminate financial markets around the world.

HOW MUCH WILL THE CONTINUING EUROPEAN SLOWDOWN HOLD BACK GLOBAL GROWTH?

It's a very large part of the global economy, between 20 and 25 percent, and the recession has definitely hurt emerging markets as well as the United States, which exports a lot to Europe. I'd be more worried, though, about lower profits from operations—and especially more instability in global financial markets.

IS ECONOMIC UNREST IN EUROPE AFFECTING WORKER MIGRATION BETWEEN COUNTRIES?

Well, labor markets are pretty open, so you already see quite a bit of immigration within Europe—big flows of people out of southern Europe and into Germany and the United Kingdom. Unemployment rates in Greece and Spain are over 25 percent; every other young person is out of work. These people move. In fact, these are golden days for foreign-language institutes—demand has been higher than ever. Migration is an important adjustment mechanism—people move where there are the highest returns on their labor.

AND WHAT ABOUT IMMIGRATION FROM OUTSIDE EUROPE? IS THAT UNDER THREAT AS PEOPLE LOSE THEIR JOBS?

When it comes to knowledge workers from the rest of the world, there's a certain openness: Most countries recognize that they can use—that they *need*—knowledge and high-skilled workers. The problem is that there's also a big inflow of people who are not bringing the skills that are needed in an already slow environment. Countries need more selective immigration policies that are really being enforced. Look at Canada and Australia, two countries

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that have sophisticated immigration systems that make sure that they're getting who they need and keep out who they don't need, and also maintain a policy for refugees that have a humanitarian need.

In Europe, it's much harder to reach agreement around these policies, since countries have different views about what they need and from which parts of the world new influx might come. Moreover, as internal borders are gone, one leak in the system affects everybody. I'm afraid that immigration policy is not going to change very quickly in Europe, and that's a drag, because the demographic problems are even bigger there than in the United States. Dealing with it would require real political courage.

WHAT ABOUT POTENTIAL IMMIGRANTS WHO AREN'T HIGH-SKILLED KNOWLEDGE WORKERS? DOESN'T BRINGING IN NEW, YOUNGER PEOPLE BRING VITALITY TO AN ECONOMY?

That is true, but it requires a change in mindset on how to get those immigrants going in their new country. Letting them in is the easy part—there's education, housing, social welfare, and health care, and all that needs to be organized and paid for. Plus, you need to have an economy that's less regulated so people can easily start new businesses. Even if you can, as is more or less the case between European countries, these small businesses need to get a chance to grow. The business environment in Europe isn't all that friendly to new start-ups.

Good immigration policies are difficult and require real commitment and wide political support. Even in the United States, a country built on immigration, there is concern about destabilizing effects from immigrants on labor markets, even though there isn't much evidence for that claim. In a world where fortunes are so different between countries, it quickly becomes unmanageable, so very clear and transparent policies are needed to allow low-skill people to come in. Effective immigration policies raise tough choices that require a lot of political support—who we let in, who we don't let in, and how many.

LET'S LOOK AT EMERGING ECONOMIES. UP UNTIL THE FINANCIAL CRISIS, ECONOMISTS REGULARLY MENTIONED CONCERN ABOUT THE CHINESE AND INDIAN ECONOMIES OVERHEATING. IN SOME WAYS, IS IT BETTER THAT GROWTH THERE IS SLOWING?

Yes—there was a real risk of overheating and inflation. India was probably going faster than its speed limit for many years—as was Brazil, which grew 7 or 8 percent in 2010, whereas its speed limit was probably around 4 percent. And the Chinese economy certainly was overheating, with inflationary pressures emerging last year. That needed to be tackled, because inflation is particularly harmful to emerging economies, where it can lead to social unrest among the poor and slow down the emergence of a middle class.

But the global crisis and weaker markets for exports have pushed the largest emerging economies below their speed limit, and these countries have tried to jump-start growth in different ways. China has been throwing more capital at the economy, especially to state-owned enterprises, and there is a lot of churning of capital in a growing unofficial gray market, which usually raises the cost of capital. Of course, the return on capital is already so low that adding more capital is not going to create significant returns.

In the case of India, the problem is actually more political than economic. The slowdown is complicated by the fact that the markets are not working very well—the government's structural-reform agenda is in ruins, with no political support. India really needs to pursue that agenda, because at least two-thirds of that economy is still not integrated into the national economy, let alone into the global economy.

In Brazil, growth has slowed well below 2 percent this year. The government has announced a lot of infrastructure investment, but that takes time to get approved and get built, so I think Brazil will improve only gradually. The country needs to become more productive and more competitive, and it needs to revamp its tax system, which is very complicated. Those are challenges that go way beyond quick money for more infrastructure.

ARE THE EMERGING ECONOMIES STILL GROWING IN THE SAME WAY AS IN THE PAST DECADE?

No, that's the biggest and very important change. Once these countries get to 40 or 50 percent of the development level of the mature economies, the growth model has to change. You need more skilled people, you need to do R&D yourself, you need companies to be able to integrate into their own value chains, and you need to give a larger role to the markets and other institutions, because things get too complex for governments to directly control. And growth naturally slows during that transition. If you have to innovate yourself, it's much harder than borrowing technology from somebody else. In a mature economy, services are more important, and services by definition have slower productivity growth; they don't add as rapidly to economic growth.

WHAT DOES THAT MEAN FOR BIG COMPANIES IN THE WEST?

I think it can be very good news for companies in advanced economies. The markets in emerging economies will be more mature and more diverse, needing more and different products and services. There will be more demand for sophisticated technology. Going forward, economic growth will be *better* growth—or at least it could be if countries don't mess it up, policy-wise.

The most important thing for Western business is to not expect that the same type of old growth can continue. It is worrying when I hear business leaders of Western companies in China saying that their head offices continue to expect double-digit growth. But these will remain strong markets with high-margin markets and great opportunities for the best companies to not only survive but thrive.

WILL WE ALL HAVE TO SHIFT OUR ATTITUDE ABOUT FUTURE GROWTH, FOR BOTH ECONOMIES AND COMPANIES?

Never expect that you can go back to an old normal. We can't go back to the economy of the late '90s and early 2000s—that was a period of extraordinarily rapid growth on the back of an IT boom, a huge amount of additional globalization, proliferation in the financial sector, and a lot of deregulation. Some of that growth was just not sustainable, and that's why the whole thing crashed. We have to accept that that cannot come back.

However, some of the gains of those times will ultimately set us up for more innovation and value creation. It might very well be better for people's quality of life, for the environment, for education and health care—again, provided we don't mess it up.

WHEN IT COMES TO EXPECTATIONS, WHAT ABOUT FOR CITIZENS OF EMERGING COUNTRIES, WHO HAVE LONG BEEN PROMISED WESTERN LEVELS OF CONSUMPTION?

The most frightening scenario is that if we are not able to fulfill the demands of the emerging middle classes, and that we are creating a really bad environment, socially and economically.

SPEAKING OF MIDDLE CLASSES IN BOTH EMERGING AND INDUSTRIALIZED COUNTRIES: I KEEP SEEING ARTICLES ABOUT HOW U.S. MANUFACTURING OUTPUT IS RISING BUT THAT, AT LEAST IN THAT SECTOR, IT'S A JOBLESS RECOVERY; MANUFACTURERS NOW NEED ONLY HIGHLY TRAINED WORKERS, AND NOT MANY OF THEM. IS THAT TREND HAPPENING ELSEWHERE IN THE WORLD?

Yes, but we shouldn't think short-term here, although I acknowledge you have no interest in the long term if it's your job that's on the line. It is true that a lot of the current technology is creating higher productivity growth and fewer jobs, replacing existing jobs. That's *existing* jobs—there will be new jobs coming around, and the question is, "What are these jobs going to be?" Of course, we don't know, but every past technology innovation has unexpectedly opened up new sectors that create jobs. One great example comes from our own Help Wanted OnLine data, which showed that the number of app jobs—the number of American workers spending time creating apps for tablets and smartphones—is now around 500,000, none of them existing a few years ago.

Also, many jobs now originate in a nontraditional labor environment. Labor markets are beginning to look very different, with fewer full-time jobs with one employer. Many jobs will be more flexible; people will work more independently and more ready to switch jobs. This has huge policy implications: Where are you going to get your insurance? Who is going to pay for your pension? We need to think hard about these issues, because again no policy change can really mess this up.

All in all, I'm reasonably optimistic that we will be able to continue to keep participation rates in the economy at a decent level. And with slowing demographics, we ultimately need *more* people relative to the population to do the job.

BUT WHO IS GOING TO CREATE THOSE JOBS? IT'S BEEN A FEW YEARS SINCE PEOPLE BEGAN URGING COMPANIES TO INVEST THE BILLIONS IN CASH ON WHICH THEY'RE SITTING, AND WE STILL HAVEN'T SEEN ANY REAL INVESTMENT. IF GROWTH WILL BE SLOWER FOR THE FORESEEABLE FUTURE, WILL CEOs EVER SEE A REASON TO INVEST AND HIRE?

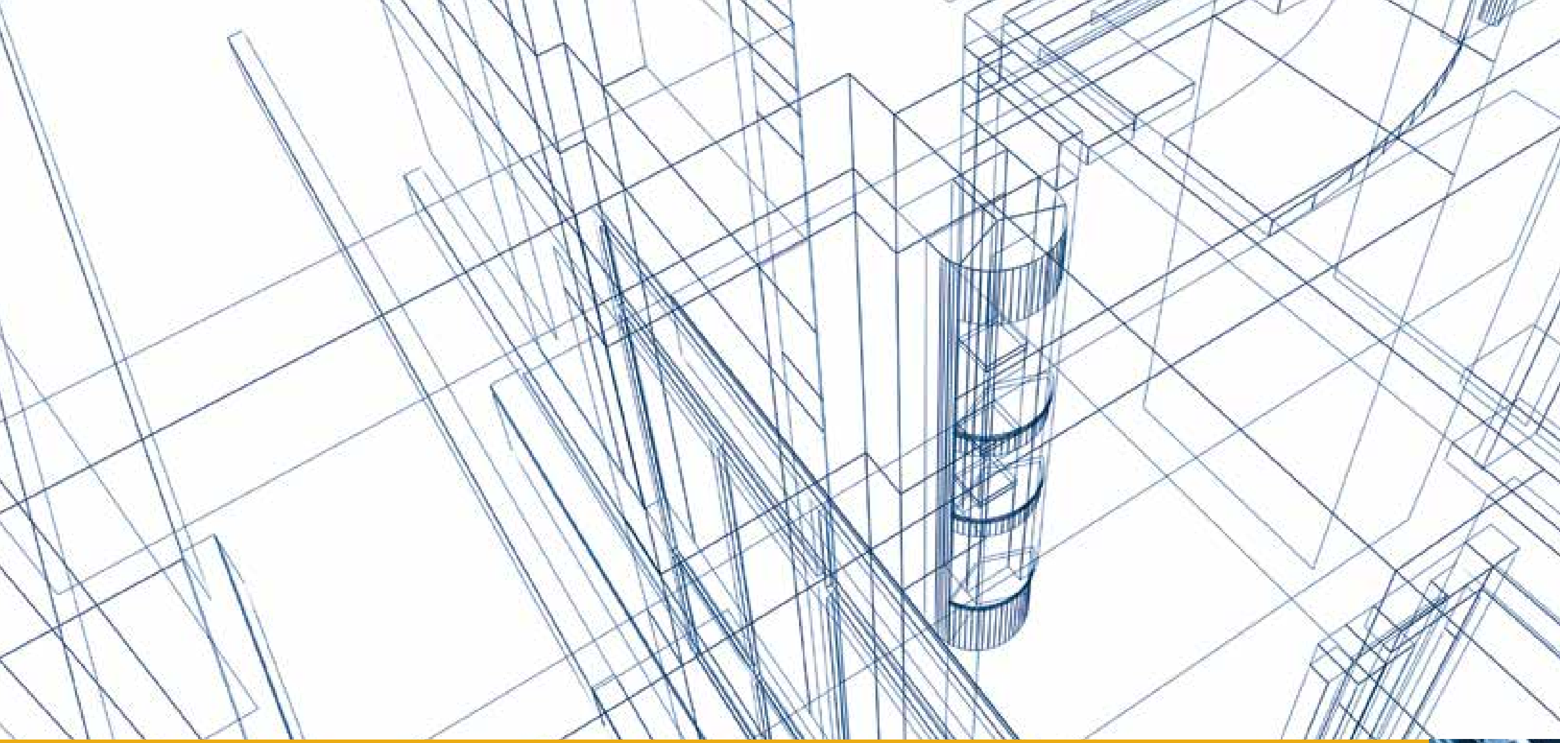
Yes, because it is confidence that needs to lead the recovery. Consumer confidence is actually doing reasonably well, coming out of a very deep hole. It may not yet be strong every month, but I think we're gaining traction with the consumer as housing markets improve and the labor market very slowly strengthens. Business confidence, by contrast, is really low, partly because CEOs are worried about the fiscal cliff and other policy changes that may or may not happen. Companies are holding back because they're just not certain whether investing now isn't creating a bigger problem for them down the road. Confidence is necessary for people to extend their perspective again and begin to look at investment cycles of five years.

IS THE U.S. POLITICAL STALEMATE REALLY PLAYING THAT MUCH OF A ROLE IN CEOs' DECISIONS?

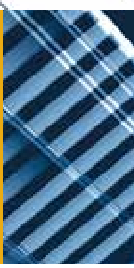
Absolutely, rightly or wrongly.

SO IF LAWMAKERS SOLVE THE FISCAL-CLIFF PROBLEM—OR AT LEAST PUT IT OFF CONVINCINGLY—SHOULD WE EXPECT A WAVE OF INVESTMENT?

If we get to a "grand bargain" anytime soon, so that we have a broadly supported deficit-reduction strategy, then we'll get more economic growth, the most important way to reduce the deficit. But we'll probably look more at a fiscal slope than a cliff, and the uncertainty is how fast we'll go down the slide before getting back on our feet. We give it half a year, making early 2013 weaker in growth than the second half of the



THIS CRISIS HAS BEEN WITH US FOR A COUPLE OF YEARS, AND IT MAY BE WITH US FOR A FEW MORE, AND WE HAVE TO ORGANIZE OUR SOCIETIES, POLITICS, AND BUSINESSES IN SUCH A WAY THAT WE COME OUT OF IT IN A BETTER PLACE.



year. The underlying dynamics of the economy seem to be strengthening.

DOES IT MATTER THAT U.S. CORPORATE PROFITS JUST HIT A RECORD HIGH?

Well, profits are nice, but if you don't see an opportunity to reinvest and to grow, your business is under a long-term threat. You can hold out longer if you have a lot of capital on the balance sheet, but it doesn't make you grow.

IF WE'RE RESETTING OUR EXPECTATIONS AND LOOKING AT SLOWER GROWTH FROM NOW ON, HOW WILL WE KNOW WHEN WE'VE RECOVERED, SO TO SPEAK?

For the U.S. economy, we would see unemployment below 7 percent and perhaps below 6 percent. And people need to see rising living standards again. Americans are seeing an ongoing decline in income growth, and that's really, really bad for the chances of recovery. On a philosophical note, I don't think you can speak of recovery if people feel that their kids will be worse off than they are. Incomes need to rise for people to sustain their lives and to increase the quality of their lives and that of the new generations.

ARE COUNTRIES FOCUSING ENOUGH, GLOBALLY, ON THE ISSUE OF UNEMPLOYMENT?

Politicians very well understand that unemployment is a time bomb for their own future and that of their constituents. In emerging economies, if many people cannot make a living or are too close to poverty level, it creates huge social unrest. In more mature economies, the bigger concern is to make sure that the participation rate in the economy remains relatively high and that people see opportunity for building their own lives, whether that is through a formal job, an informal job or a volunteer job or staying engaged with society in other ways—something important or valuable to do. That's more important than the absolute rate of unemployment. But we should be able to sustain a high participation rate in the economy.

SO THE NUMBERS LOOK MORE GLOOMY THAN THE REALITY?

The numbers point at the challenge ahead of us. The reality is that things will get better. They always do. The question is where and when and how. We need to make sure that it happens sooner rather than later and that it happens in a way that is benefiting a broad section of our economy and population.

Some say we are at a tipping point. Maybe. I'd argue for some reflection, too. This crisis has been with us for a couple of years, and it may be with us for a few more, and we have to organize our societies, politics, and businesses in such a way that we come out of it in a better place. ■