
Robeco Summer Sessions

Session 3:

Economics and the environment – changing paradigms?

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interviewed by Brendan Maton, financial journalist**

Economics and the environment – Changing paradigms?

Is this the worst economic situation you have ever witnessed?

It is by far the worst financial crisis I have ever seen. By the time this recession is over, I think we will look back and decide it was the deepest and the longest recession since World War II.

You say there is going to be no depression. But if we look at the figures: Japan's GDP is down 8.5% this year, and Germany's GDP is predicted to contract by about 6.5% this year. Surely these are bad times for certain countries in Asia and in Europe?

Well, it is important not to extrapolate the disastrous figures we have indeed seen recently in Germany and Japan and other places as well. I mean, Brazil fell off the cliff in the last quarter of 2008; these are all countries that have relatively large manufacturing sectors, and they had the world's biggest inventory cycle. People just slashed inventories. And that is bad when it happens. But the good news is, once the inventories are gone, you cannot make them go twice. There is a natural floor under the stock of inventories. Once they hit zero, they cannot go any lower. And basically, a lot of industry in Japan, especially, has reached that floor, and you will see an inventory recovery in Japan over the next couple of quarters, which will be almost as steep as the decline. That does not make for a complete recovery; it simply means that the extremes of the inventory cycle are going to be reversed, but then the recovery will depend on the growth of final demand: household consumption, investment - both private investment, household investment

in housing and durables, and government investment. And that will take longer.

Because the financial sector in most of the overdeveloped world has been so devastated, so badly impaired (both the banks and the capital markets) that the external financing that is integral to a rapid and strong recovery is likely not to be in place. So we are likely to see a recovery, yes, but one that is slow and anemic.

And this slow and anemic recovery will last until 2011, 2012?

Before unemployment returns to the levels it was at before this crisis started; before the output gap, the gap between actual GDP and potential GDP is closed, it could easily be 3, 4, even 5 years. So we will be growing, but we are likely to be growing at a rate that is below the growth rate of potential output; and so the output gap will be rising even as output is growing, and unemployment may well be rising for years.

So if there is this output gap, what does that mean for GDP growth? Can you give us your best-case estimates?

It depends on what part of the world you are looking at. The world as a whole is likely to grow at a rate between 2 and 3% for 2009/10. This is below the growth rate of world potential, so we are going to have to see a strong recovery there; they will still have not a recession, but a so-called growth recession (when you grow below potential). But America and the UK (which went into the downturn slightly earlier in Europe) are likely to come out of it earlier; in

continental Europe, the eurozone especially, the cleaning up of the mess on the balance sheet of the banks has not really started yet. And even the recognition of the losses has not really started yet, except in a few individual cases. So I think there is a lot more financial stress to reap in continental Europe. The recovery is likely to be delayed well beyond that in the US and the UK, where people have not been excessively brave in coming clean and recapitalizing the banks, but they have been less pushed than the continental European supervisory regulators.

So Europe's banks are still causing problems for the economy. Does this mean, if we turn to Asia, that they are just in far ruder health, and in terms of GDP, it's a much brighter story?

Asia is a big place and it is a very heterogeneous collection of stories. After all, Japan is in Asia and they are not doing so well. What you can say is that countries that will do well, whether in Asia or not, will have to satisfy a number of criteria. The financial sector should be defunked or badly impaired. They should not be too dependent on foreign trade. They should not be too dependent on foreign financing. And fiscally they should be in reasonable shape. Well, there are just two countries that satisfy all these criteria. That is North Korea and India. North Korea is not going to do much for us. India a bit more, but they are too small. China has three out of four and so has Brazil. China is very dependent on export growth, and that is a problem. Because they must – in order to get out of this – redirect their demand from



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export-led demand to domestic demand and, preferably, consumer demand. Not only do they have to redirect demand, they have to shift production, and that takes time. Because the kind of goods they were exporting to the US and Europe before are not necessarily the same kinds of goods and services that Chinese consumers will want. Can they do it at a speed that is appropriate to working off their bit of the global downturn and help in averting the process, perhaps. The prospects are certainly better, I think the Chinese government is robustly predicting 8% growth or so this year. These figures are very much central-plan-bureau Chinese-style figures. They should not be taken too seriously because statistics in countries like China are not primarily data and information, they are propaganda tools and instruments of policy themselves. But there is evidence with supporting data that growth is picking up again in China and in a number of other Asian countries, but by no means everywhere.

But India again, is it an investment place?

It is not dependent on external funding, nor on external growth. They are not in great fiscal shape, but they have enough domestic elbow-room to push demand. So these are the kind of countries, when you add them all together: China, India, Brazil, a few other places like that, where you do not have a locomotive pulling the world economy, but you have the beginning of the little engine that could.

You talked about the environment. Can you tell us more in respect of India and China?

These days, when you talk about the environment, people immediately think of global warming and emission of greenhouse gases. And I think there China and India are becoming very much central to a solution to the problem. China has now become - in terms of the flow contribution of greenhouse gases - the biggest global polluter, having overtaken the US. Of course, in terms of cumulative contributions over the ages, America is still well ahead, as is Europe. But in terms of new contributions, it is the emerging economies that are doing most of the damage. But that is sort of a global problem. If you just look at problems that affect only the region, China

and India are going to have a disastrous level of scarcities of fresh and clean water, fertile usable soil, and indeed clean air. The Chinese mode of industrialization has been one which is as poison-intensive as anything ever produced in the history of humanity. China is a bit more service-oriented, so it bilges out somewhat less rubbish, but India, too, has deforestation and dessification problems on a massive scale, as has China. So even if you are not looking at the global picture of what they do to global warming, but what they do to local destruction of habitats, air, water and land, those are three things you need, and they have not yet even begun to address this on a scale that it needs to be addressed on. They are running out of time.

In addressing that problem, do you foresee resource wars? People fighting over water?

I think that most wars starting now are likely to be fought over water, rather than over oil or gas, yes. It is going to be the scarce and conflict-driving commodity of this century. OWEC, the not-yet-existing organization of water-exporting countries, will be more powerful than OPEC in 20 years.

And for Europe, does that mean we need a standing army, sooner rather than later?

I do not think standing armies will help here. The only thing that will help is ways of conserving and purifying water and preventing dessification and pollution. There is again enough of everything to go around. We just have to price it properly; that means making things that people have taken for granted as freebees expensive. That is going to be politically difficult, but it is certainly preferable to war.

There are loads of organizations involved in this. Can you think of a more effective, simpler way of getting policy-makers together in action?

No, I think that the only thing that will trigger action is some spectacular local disasters of the environmental variety. A region, a province, running out of water. Massive pollution, soil pollution, that make a city uninhabitable, that kind of style. They will have to unfortunately expect that mere warnings will not cause action. It is only the manifestation of at least the tip of the damage of the iceberg (damage

that could be done) that will prompt political action.

Do you think that the US will remain the world's economic super power?

The US will come out of this crisis and great contraction diminished. It will still be the world's largest economy; it will still be about a quarter of world GDP. But the period in which it could act as the world hegemon, the dominant economic, political, military, even cultural power in some ways, is drawing to an end rapidly. Especially the Bush-junior decade of American unilateralism, with the Soviet Union having imploded and China and India not yet ready for prime time. The US was basically the only show in town. That is gone. And specifically, I think, elements of the cultural sense of superiority in the broader sense of the West, and of the US in particular, have been fairly damaged. The belief that the lightly regulated or self-regulated market system, especially the financial system, was not a system that brought America great wealth and prosperity, but was something to be exported to the rest of the world and emulated by everybody else. This has taken a huge beating. The American variety of financial capitalism is, I would say, mortally wounded, if we are going to have to reconstruct a different type of capitalism. It will still be capitalism, it will still be largely privately owned and driven, but it will be less reliant on markets, more reliant on long-term relationships, it will have a greater role for the State than the ideologues of the free market believed. So there has been an ideological, cultural diminution of the US, as well as an undermining of its financial, economic, political and, indeed, military clout.

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