Another false dawn or reason for optimism?

April 15, 2012 8:00 pm by Financial Times

By Eswar Prasad and Karim Foda

The world economy is showing scattered signs of vigor but remains on life support, mostly provided by accommodative central banks. Concerns about spillover from a worsening of the European debt crisis and slowing growth in key emerging markets are putting a damper on consumer and business confidence. Equity markets are pulling back from a robust performance in the first quarter of this year as the sobering reality of a continued anemic recovery weakens investors’ optimism.

There are some positive signs in the latest update of the Brookings Institution-FT Tracking Indices for the Global Economic Recovery (TIGER), but also much to worry about as the world economy continues to meander with no clear sense of direction.

In advanced economies, there is considerable uncertainty about what room is left for aggressive policy responses to counteract weak demand and, in any case, whether those measures will get much traction. With fiscal policy already in a tight spot and monetary policy out on a limb in these economies, the room to boost domestic demand is limited.

The eurozone debt crisis, which has eased temporarily due to massive intervention by the European Central Bank (ECB) as well as promises of fiscal discipline and structural reforms in the distressed economies, remains the major source of global risk. Many European economies are being forced to restructure their public finances even as they venture to undertake massive structural reforms. This is stifling growth, worsening debt to GDP ratios in the short run, and generating an unsustainable political situation at the domestic and pan-European levels.

Political uncertainties are also increasing concerns about whether nimble and
concerted policy responses will be forthcoming if economic prospects were to
deteriorate. Many countries, including the US and France, are heading into election season while China’s leadership transition has hit some roadbumps. There is a serious risk of nationalistic sentiments being whipped up and giving rise to protectionist pressures that could hurt trade flows and add to macroeconomic uncertainty.

The US recovery is gradually firming up but remains fragile. Output growth has been modest at best but the unemployment rate continues to drop and employment growth has begun to pick up, even if haltingly and at a pace that still leaves total employment below its pre-crisis level. Equity markets turned in a good performance in the first quarter of the year while credit growth has picked up, helping to give consumer and business confidence a small but noticeable boost.

Europe remains the flashpoint for problems that could derail the global economic recovery. Many of the distressed European economies are mired in negative growth, others including France are at the edge of recession, and even the mighty German economy appears to be stumbling.

There is a growing sense that Europe has the capacity to summon just enough political will to pull back each time from the brink of a full-blown crisis but without ever reaching a decisive resolution. The severity of market tests of policymakers’ resolve is likely to increase and could force a denouement sooner than anticipated.

The burden of sustaining world growth is taking a toll on emerging market economies, whose growth momentum has weakened and led to a significant markdown of their growth expectations for 2012.

China seems to be engineering a soft landing for its economy, although this will not be a smooth process as the economy continues to be buffeted by domestic policy challenges and uncertainties in the global trade and financial environment. If growth were to slow sharply, China has room to respond with aggressive expansionary policies. This would secure short-term growth but could set back the long-term goal of rebalancing economic growth and making it less reliant on investment.

India has hit a rough patch, with industrial production growth hitting a wall at the end of 2011, output growth slowing sharply, and the current account deficit widening and leaving the economy vulnerable to capital flow reversals. Brazil, Russia, and most other emerging market economies have also experienced slowdowns in GDP growth, with industrial production growth taking a sizable hit.

Four years after the financial crisis drove the world economy to the brink of
collapse, the pervasive sense of imminent doom has given way to cautious optimism. However, the global economic recovery is still sputtering due to a lack of robust demand, policy tools that are stretched to their limits and unable to muster much traction, and enormous risks posed by weak financial systems and political uncertainty.

_Eswar Prasad is a professor in the Dyson School of Applied Economics and Management at Cornell University, and a senior fellow at the Brookings Institution. Karim Foda is a research analyst at Brookings._

Tags: Brazil, China, ECB, eurozone, France, Germany, India, Russia, US
Posted in Economics, Emerging Markets, Eurozone, Fiscal policy, UK economy, US economy | Permalink