FINANCIAL TIMES

Last updated: November 1, 2011 10:25 pm

Cannes conundrums

By Alan Beattie

G20 delegates are preoccupied by upheavals in the eurozone

A world on their shoulders: Nicolas Sarkozy, G20 chairman, is to hosting a meeting of world leaders in Cannes towards the end of the week

Whatever Nicolas Sarkozy envisaged dominating his moment at the centre of global economic governance, the question of whether the indebted and embattled Greek government would survive a hastily called confidence vote was probably not it.

Despite the French president’s valiant efforts to focus attention on his country’s agenda for the Group of 20 leading nations, of which he is currently chair, this week’s meeting of heads of government in Cannes will be dominated by the failure of a string of mini-summits decisively to bring Europe’s escalating sovereign debt crisis under control.

But if the eurozone is the bad news, the worse news is that the global economy still suffers from the same serious imbalances as it did before the financial crisis – and that this year's political developments are likely to make them harder, not easier, to resolve.

"For the second time in three years, the world is on the brink of a global recession," says Jan Randolph, head of sovereign risk at IHS Global Insight, an economic consultancy. "This time the catalyst is the eurozone debt crisis."

The quality of global and particularly eurozone policymaking at the moment is failing to instil confidence in investors, businesses and households. Last week, a wearyingly familiar pattern repeated itself. A convocation of eurozone leaders made ambitious-sounding promises to build a firewall around Greece by boosting the European financial stability facility bail-out fund; strangely credulous investors produced an initial jump in the euro and in eurozone bond and stock prices. But within days, markets sank again as details remained vague and political will was deemed highly uncertain – then dropped sharply as George Papandreou, Greek prime minister, stunned fellow eurozone leaders by announcing a referendum on the terms of the bail-out.

Economists are issuing increasingly pessimistic warnings about the outlook. Indices of activity by purchasing managers, and other forward-looking indicators, suggest the eurozone may be back in recession already. The potential for global fallout has hardened the rhetorical tone from G20 members, particularly the US, with reassuring calm giving way to public alarm.

Angela Merkel, Germany's chancellor, will be at the meeting in Cannes

Yet even if the eurozone's immediate problems can be solved, the world economy remains dependent on consumption by countries such as America, which run chronic fiscal and current account deficits, rather than those with surpluses, among them Germany, Japan and Asian emerging markets. According to a recent report by International Monetary Fund economists: "The dual rebalancing acts needed to secure strong, sustainable and balanced growth – a handover from public to private demand in major advanced economies, and stronger domestic demand growth in external surplus economies – have stalled."

At this stage of a recovery, particularly from such a steep drop into recession, growth would normally rebound sharply as consumer demand picked up and companies scrambled to increase their investment and rebuild stocks after running them down during the contraction.

But last week's brief burst of optimism in the US, when gross domestic product growth numbers for the third quarter were stronger than expected, merely underlines how far expectations have fallen. GDP in real terms expanded at an annualised rate of 2.5 per cent in the three months, nearly double the 1.3 per cent annualised rate in the second quarter, largely driven by a recovery in private consumption. However, that only just took the level of real GDP above its peak 15 months ago before it plunged into recession. The economy at this stage in the previous four US recoveries from recession was 10 per cent above its pre-recession peak.

Hu Jintao, China's president, will be in Cannes

Paul Ashworth at Capital Economics points out that consumption was funded not by robust income growth but by Americans saving less, an echo of the unsustainable credit-fuelled spending binge during the boom of the 2000s. The personal savings rate as a share of disposable income dropped to a four-year low of 3.6 per cent in September. "It is hard to see this faster pace [of consumption] being sustained for that much longer when real personal disposable incomes contracted by 1.7 per cent in the third quarter," he says. For now households may have halted the process of deleveraging after the huge debt loads they built up but it seems unlikely that they have finished.

It is doubtful how long such a recovery in consumption will continue as long as unemployment remains so high and the prospects for income growth weak. The increase in non-farm payrolls, the most closely watched measure of the US jobs market, has slowed this year to a pace of expansion well below the trend growth rate in potential workers entering the market. The headline unemployment rate remains stuck above 9 per cent, and broader measures including those forced to take part-time work have risen much higher.

• • •

Even this burst of growth is heading for the quicksand next year if, as planned, the US fiscal stimulus is withdrawn. Barack Obama, president, has so far largely failed to convince Congress to pass a plan that would increase government spending and extend temporary tax cuts due to expire next year, with John Boehner, the Republican speaker of the House of Representatives, assiduously blocking such moves. The spectacle of the debate over raising the federal debt limit in August seems likely to be repeated when the next public financing deadline comes up this month.

Barack Obama, US president, has so far failed to persuade Congress to pass a plan that

The US continues to urge other countries to keep government spending going, yet on current projections it will impose one

would increase government spending

of the fastest fiscal tightenings in the G20 over the next year. Mr Obama is essentially in the position of saying: “Do as I say, not what John Boehner makes me do.”

The hazards of premature fiscal tightening are evident in the UK, where feeble GDP numbers published this week underlined the gamble taken by David Cameron’s right-of-centre coalition government in cutting public spending before the economy had gained momentum.

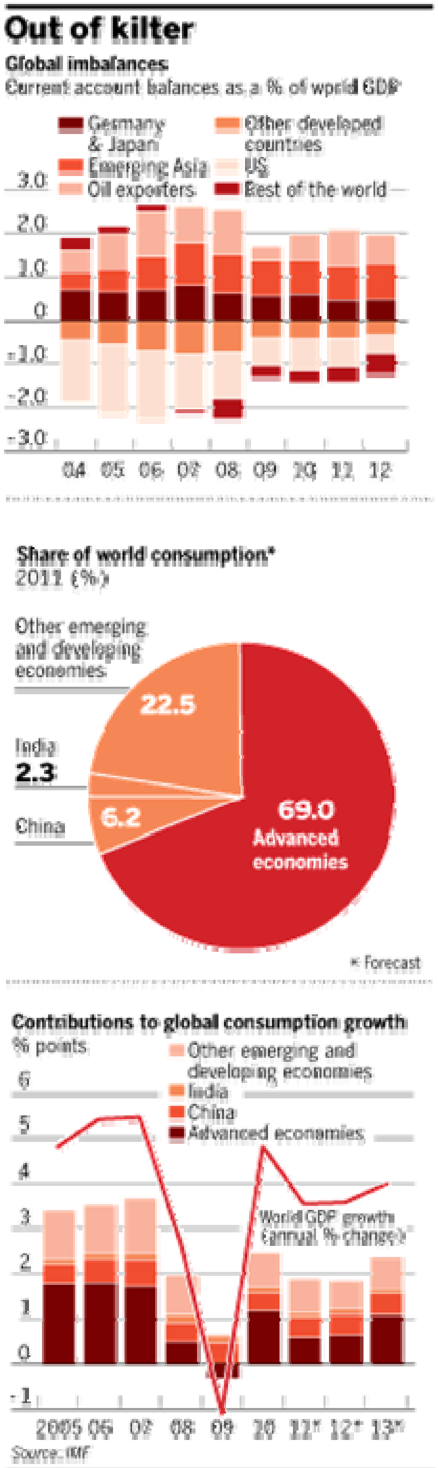
• • •

Meanwhile, emerging markets as a whole are unlikely to fill the gap left by weak consumption in the advanced countries. Despite, for example, the repeated assertions of Chinese leaders that they want to shift to a consumption-driven model, the incentives for the perpetuation of an export- and investment-based economy remain. Beijing continues to hold down the renminbi – the currency has risen less than 4 per cent against the dollar this year despite entreaties from the US for faster appreciation. And the state, at least through provincial governments, continues to shovel cheap money at favoured companies.

Whether China’s apparently overheated property market is indeed in a bubble, and whether that bubble will pop in the near future, is the subject of intense and abstruse debate among economists – but there is certainly a non-negligible risk that even the country’s current underpowered contribution to global consumption could be further reduced by such an outcome.

Current account imbalances shrank during the worst of the global recession. But that was caused mainly by lower demand in the US and Europe temporarily sucking in fewer imports from China, not by a fundamental rebalancing of consumption. The IMF calculates that Chinese consumption would have to have risen by 17 per cent in 2009 to make up for the shortfall in US demand, with the national savings rate falling by about 10 percentage points. Needless to say, that did not happen, and as the recovery took hold last year, so the imbalances began to open up again.

In any case, the emerging markets as a group have such a small share in global consumption, much



smaller than their share in overall GDP, that it would have to expand dramatically to offset the effects of slower growth in the advanced economies. The IMF thinks that, if anything, emerging market countries as a whole are likely to contribute a smaller share of global consumption in the years ahead than before the crisis hit. "These economies do not make up for the lower consumption contribution of advanced economies," the fund concluded. "Although the rebalancing journey may have started, based on announced policies it will likely take a long time to complete."

Washington will continue its long campaign inside the G20 for Beijing to allow a faster appreciation of the renminbi to assist in global rebalancing. But its record of success is undistinguished – as, more generally, is the group's record of persuading large countries to change their minds on big economic issues. Eswar Prasad at the Brookings Institution, a Washington-based think-tank, says the G20 "has not proven effective at resolving policy conflicts among its members or helping to overcome domestic political gridlock".

At the moment, the moral authority of the US and other rich economies over China is particularly weak. America's contribution to a big rebalancing would be to consolidate its medium-term fiscal position, helping to reduce the current account deficit. But while Congress is on course sharply to withdraw the fiscal stimulus in the short term, it has yet to come anywhere near agreement on long-term spending and tax plans. The "supercommittee" commissioned by Congress with the unenviable task of identifying expenditure to be cut and/or taxes to be increased will not report until later this month, and the likelihood of it coming out with a plan that rapidly gains bipartisan support is low.

Of the other advanced economies, Japan's resumption of intervention to hold down the yen on Monday makes it supremely badly placed to join any drive against Chinese currency manipulation. The eurozone, too, is unlikely to participate in any aggressive public crusade to float the renminbi in the near term. Klaus Regling, head of the EFSF, is travelling around Beijing and other Asian capitals trying to drum up interest in funding an expansion of the bail-out facility. A decision on whether they will contribute is still awaited, but China will look very dimly indeed on governments that ask for donations while running a voluble campaign against the mainstay of its economic model.

Ousmène Mandeng, a former senior IMF official now at Swiss bank UBS, says it has been a bad year for global policy co-ordination in general and the G20 in particular. "Sadly, the G20 missed a great opportunity to remain visible during the crisis this year," he says. "Failure to address critical issues and to guide market expectations when the going was rough has undoubtedly weakened its relevance."

Additional reporting by Chris Giles

BACKGROUND NEWS

Low-level exchange rate hostilities with occasional flashpoints have dominated what have become known over the past 18 months as the international "currency wars", **writes Chris Giles.** With hot money seeking a safe home, countries can find themselves confronted with a wall of capital and scrambling for tools to prevent their currency appreciating in a way that disrupts local economies.

Whether it is China's accumulation of thousands of billions of dollars in foreign exchange reserves, Japan's sporadic interventions on currency markets, the Swiss ceiling on the value of its franc, Brazil's efforts to tax inflows of capital or the US Senate's vote to punish Beijing for seeking to hold down the renminbi, the currency wars cast a shadow over the global economy.

If ever there was an area ripe for Group of 20 co-ordination for the good of the global economy it would be currencies, since a depreciation for one is an appreciation for everyone else. Yet so difficult is international discussion of the topic that all that can be agreed are largely meaningless formulations to which everyone is willing to sign up.

The current G20 favourite – repeated at the finance ministers' meeting in Paris in mid-October – runs: "We reaffirmed our shared interest in a strong and stable international financial system, and our support for market-determined exchange rates. We reiterate that excess volatility and disorderly movements in exchange rates have adverse implications for economic and financial stability." While the first sentence pleases the US and those seeking greater currency flexibility, the second is cited by China as backing for its policy of managing the renminbi.

Given the narrow scope for unity, G20 participants often arrive saying currencies will form an important part of the talks, only to leave admitting that there was almost no discussion of the issue. But in 2011 all this was supposed to change. Under France's G20 leadership, President Nicolas Sarkozy's plan was for China to be offered the renminbi's inclusion in the currency basket that forms the International Monetary Fund's special drawing right if it gave ground on efforts to weaken its currency.

France appears to have secured some form of agreement of conditional renminbi inclusion in the SDR. The trouble is that its likely implementation is so far into the future that this again will show the G20 impotent in resolving the current currency wars.