FINANCIAL TIMES

Global economic recovery hits the ropes

October 7, 2012 5:00 pm by Financial Times

By Eswar Prasad and Karim Foda

The global economic recovery is on the ropes, battered by political conflicts within and across countries, lack of decisive policy actions, and governments' inability to tackle deep-seated problems such as unsustainable public finances that are stifling growth. Growth in global trade has weakened and the spectre of currency wars, with countries looking to maintain export competitiveness by keeping their currencies weak, has returned to the fore.

The Brookings-FT Tiger index shows growth momentum has dissipated in nearly all major advanced and emerging market economies. Central banks of the major advanced economies have responded with a range of conventional and unconventional policy monetary policy actions. These measures have put a floor on short-term financial market risks but have been unable to reverse declining growth momentum. As a result, financial markets continue to go through short-term cycles of angst and euphoria even as indicators of real economic activity remain mired in weakness.

The US economy remains the sole bright spot, with economic activity, employment and financial markets all showing unexpected although still modest strength. There are signs housing markets have stabilised in many hard-hit areas, which could set the stage for a rebound in consumer demand. The Fed's aggressive approach of combining unconventional monetary policy measures and forward guidance of a low interest rate path through 2015 seems to have contributed to a more benign outlook. However, the looming fiscal cliff and the prospect of continued political gridlock after the presidential elections is putting a damper on business and consumer confidence.

Growth in the core eurozone economies, including Germany and France, has slowed sharply while the eurozone periphery remains in free fall. Eurozone financial markets revived briefly in the wake of the ECB's actions to directly support the financing needs of governments that commit to fiscal austerity and structural reform measures. It seems increasingly unlikely, however, that governments of periphery countries such as Spain can overcome the popular resistance to such measures. Consequently, sentiments have turned negative again and are contributing to a slowdown across the eurozone.

The Bank of Japan has been uncharacteristically aggressive in employing a broad range of unconventional monetary policy measures to support growth, in part by limiting appreciation of the yen. The economy has not responded positively to these measures, however, and they have only created a temporary respite for Japanese financial markets.

Emerging markets are running out of steam as their available policy space becomes increasingly constrained and they continue to be buffeted by adverse external factors, including a weak global trade outlook and volatile commodity prices.

The outlook for China's economy has turned gloomier as numerous indicators suggest a slowdown that threatens to push growth below the government's target of 7.5 percent. Weaknesses in major export markets, the overhang of excess capacity from the 2009 to 2010 bank-financed investment surge, and a weak housing market have all hurt aggregate demand.

China may be holding back some policy firepower to deal with further unfavourable developments abroad, but policy options to restore growth will become increasingly constrained if the slowdown intensifies. Political intrigue and jockeying in the lead-up to the leadership transition also appear to have contributed to the lack of a decisive and concerted policy response.

In India, recent reforms have created a surge of optimism that more are on the way and that the government may finally start to rein in the budget deficit. The pushback against the reforms has created some short-term political uncertainty that is holding back economic activity and financial market performance. While the reforms do not directly address India's vulnerabilities such as its large budget and current account deficits, the overwhelming sense of malaise has been replaced by guarded optimism.

Latin American economies have hit a rough patch, with countries like Argentina and Brazil experiencing significant slowdowns. In Mexico, strong export performance has kept growth more stable than in other countries in the region.

With fiscal policy and other policy tools hamstrung by high debt levels and political uncertainty, monetary policy remains the first and often only line of defence in most G20 countries. Central banks are being forced to continue shouldering the twin burden of limiting downside risks and stimulating growth, resulting in reduced traction for monetary policy in boosting growth and also setting the stage for future financial system imbalances. In the absence of a broader range of decisive policy measures – including fiscal, financial system and structural reforms needed in many countries – the world economy may soon be down for the count.

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: TIGER
Posted in Central banks, China, Eurozone | Permalink