A threat of double-dip recession is stalking the world economy. Advanced economies are struggling to raise insipid growth rates, while the fast-growing emerging economies cannot maintain their previous momentum. If anything goes wrong – and there are known potential shocks in the coming months – the risk is rising of a dangerous economic slide.

The Brookings Institution-Financial Times Tracking Indices for the Global Economic Recovery shows a steep drop in 2012 so far, leading professor Eswar Prasad of Brookings to describe the global economy as “on the ropes”.

In the International Monetary Fund’s twice-yearly World Economic Outlook, published this week, Olivier Blanchard, the fund’s chief economist, said the world economy was hamstrung by uncertainty, which was preventing companies from investing and households from spending.
"Worries about the ability of European policymakers to control the euro crisis and worries about the failure to date of US policymakers to agree on a fiscal plan surely play an important role, but one that is hard to nail down," he said.

The renewed concern about the health of the global economy marks a depressing return to fear after an initially strong global recovery. World output jumped 5.1 per cent in 2010, a figure which dipped only to 3.8 per cent in 2011 even with the eurozone crisis pulling the rug from under previous optimism last year.

The hope was that 2012 would witness a return to more rapid expansion, but the latest IMF forecasts now expect only 3.3 per cent global output growth, split between 5.3 per cent expansion in the emerging world and 1.3 per cent growth in the developed world. So the slow descent back towards recession – defined as global growth below 2 per cent – is a big worry for the whole world, rather than one part of it.

That raises a big question for central bankers and finance ministers arriving in Tokyo this week for the IMF and World Bank’s annual meetings: are the world’s problems in 2012 a temporary glitch in a long march forward, or are fears justified that the last few months of this year are but a phoney war before the crisis again rears its ugly head?

The answer depends primarily on events in the US and the eurozone.

The US, still the world’s largest economy, is pivotal for the global outlook. With the presidential and congressional elections imminent, its economy is still growing at a moderate pace close to 2 per cent a year. This recovery, however, is not sufficient to reduce unemployment quickly. One good month’s data in September brought the rate below 8 per cent, down from a 2009 peak of 10 per cent, but the decline in joblessness is slow for a US recovery and is undermined by evidence of a significant body of discouraged workers who are not officially unemployed.

In response to what Ben Bernanke, Federal Reserve chairman, called a “far from satisfactory” recovery, the central bank launched an ambitious and open-ended third round of quantitative easing in September, under which the Fed committed to create at least $40bn a month. It said the money would be used to purchase mortgage-backed securities and would continue for as long as “outlook for the labour market does not improve substantially”.

Even with the Fed’s brute force, the fear in international circles is that its action will be undone by politicians unable to stop the US economy falling over the edge of what is known as the “fiscal cliff”. Unless existing legislation is repealed, the US authorities will impose tax increases and spending cuts of 4 per cent of national income in January 2013.
With fiscal policy a live election issue, there are no bipartisan efforts as yet to mitigate the cliff and although most experts expect the issue to be resolved after the November 6 elections, the precedent from 2011 suggests brinkmanship will ensure uncertainty continues to the last minute.

Gerard Lyons, chief economist of Standard Chartered bank, says minds will be concentrated by the certainty of a new recession if no agreement is struck. “So bad is this outcome that it is unlikely to happen, as neither party could shoulder the fall-out. More likely, there will be a last-minute compromise ... The trouble is that any decisions need to be agreed before year-end – in the so-called ‘lame-duck’ session of the US Congress.”

If the US suffers from an uncertain political and economic outlook, the eurozone situation is more critical, even though a period of calm soothed the eurozone over the summer. Comments by Mario Draghi, president of the European Central Bank, that he would do whatever it took to ensure the euro remained a stable currency were well received, as was the policy announced a few weeks later of “outright monetary transactions” by the ECB.

These will give it potentially unlimited monetary firepower to bring down short-term borrowing costs, so long as the nations sign up to a deficit-reduction programme imposed from the outside.

Other welcome developments for the eurozone have included the highest German court ruling that the European Stability Mechanism, the new rescue fund, did not breach the German constitution, and Dutch elections demonstrating public support for political parties keen to make the euro project work.

But after months of prevarication, the summer’s progress still requires significant further action before the eurozone can be stabilised and confidence can return.

Member states need to agree the definition of banking union, which is aimed at breaking the vicious circle that exists between weak sovereign states in the eurozone and their weak banks. Parts of the core of Europe want a minimal agreement on a common European banking supervisor of only the largest banks, with sovereign states remaining responsible for bailouts of failing banks.

The periphery naturally wants to socialise the risks surrounding its banks and introduce common deposit insurance. In early October, the two sides were as far apart as ever.

The issue of Greece – where the economic numbers are again slipping behind the latest eurozone/IMF programme and disbursements of loans have been held up – cannot be ignored for much longer. The IMF is playing tough, unwilling to lend into a programme it sees as off-track and where the Greek government has not lived up to promises of structural reforms.
European governments are more understanding, but a resolution of the impasse is needed soon to prevent the nation running out of money.

It is also looking ever more likely that Spain, too, will need to apply for a formal EU/IMF programme to trigger the ECB purchases of bonds, but Mariano Rajoy, Spain’s prime minister, is still holding out. And all the while, the eurozone economy deteriorates. The IMF predicts it will contract by 0.4 per cent before doing little better than stagnate in 2013.

With so many reasons to fear the eurozone crisis will deepen one more, Christine Lagarde, managing director of the IMF, has again called for “urgent action” to see “co-ordinated implementation – multiple players playing one game”.

If the two largest economic areas are facing big risks in the months ahead, emerging economies are struggling to maintain the momentum with which they started the year. No longer does anyone believe they have decoupled from advanced economies.

In October, the World Bank cuts its forecast for Chinese growth to 7.7 per cent from 8.2 per cent in May, the lowest rate of expansion since 1999.

With a once-in-a-decade change of Chinese leadership imminent, the low current rate of growth, worse than that achieved in the depths of the financial crisis in 2009, is further unsettling the world’s second-largest economy.

China’s weakness is mirrored in other large emerging economies. Brazil’s economy has slowed dramatically in response to policy tightening to restrain excess and the global slowdown. Latin America’s largest economy is expected to expand by only 1.5 per cent this year, while India’s growth rate is likely to be around half of the 10.1 per cent it achieved in 2010. Even oil-exporting countries, such as Russia, have felt the effects of the uncertainties.

With new weakness, monetary policy around the world is attempting to stimulate demand growth even though it is near its limit of effectiveness.

For most countries, the fiscal room to limit deficit reduction programmes is small and precludes much action. So all eyes are on the US and eurozone to take the steps necessary to remove uncertainty and build a little confidence.

If successful, Mr Blanchard says he would be “happy if [the IMF’s] baseline forecasts turn out to be inaccurate – in this case, too pessimistic,” but no one is counting their chickens.