BACK FROM THE BRINK, BUT A TOUGH ROAD STILL AHEAD FOR THE G-20

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OVERVIEW

The world economy took a pounding during the financial crisis. Just as it was finding its feet, the European debt crisis rocked it back on its heels. Despite all the warnings of doom, the world economy has in fact been quietly mending itself. The economic picture looks far better now than it did a year ago although some rough patches lie ahead.

The recovery has been supported by an extraordinary amount of fiscal and monetary stimulus. The major challenge for G-20 leaders is to design and time the exit from these stimulus measures in a manner that doesn't stall the recovery but helps secure medium-term fiscal and financial stability.

POSITIVE DEVELOPMENTS

The new Brookings-*Financial Times* TIGER (Tracking Indexes for the Global Economic Recovery) takes the pulse of the world economy and individual G-20 economies. It is a composite measure that combines information from indicators of real economic activity (GDP, employment, industrial production, trade), financial indicators (stock market indices, stock market capitalization and, for emerging markets, bond spreads relative to U.S. Treasuries) and indicators of business and consumer confidence.

The composite indices reveal five dominant themes. First, the global economy turned the corner by mid-2009 and has strengthened gradually since then. Growth rates of many indicators rebounded strongly after plunging into negative territory during 2008. These high growth rates are starting from a lower base and there is still a lot of ground to make up before the indicators are back at their pre-crisis *levels*. For instance, growth rates of industrial production in many G-20 economies are now higher than before the crisis but, because growth rates fell sharply during 2008, the levels of industrial production are still below pre-crisis levels. Still, the recovery has clearly gathered momentum. Some indicators such as global trade are already at or slightly above their pre-crisis levels.

Second, the recovery has been uneven. Growth rates of industrial production and trade volumes have recovered strongly, while the recovery in GDP and employment has been modest at best.

Third, the performance of world financial markets outpaced that of key macro variables in 2009. In recent months, however, financial markets have dipped, partly because they have been rattled by the problems in Europe. This could signal difficult times ahead or might be just a temporary pullback from an earlier surge of unfounded optimism.

Fourth, confidence measures have regained some of the ground they lost during the worst of the crisis. Business confidence is still rising gradually but consumer confidence in advanced economies has been stuck in a rut in recent months. Resurgent business confidence is a positive sign as it could boost investment.

And finally, emerging markets felt the effects of the global crisis later than the advanced economies and have also recovered more sharply, with particularly strong recoveries in China and India. So far in 2010, emerging markets are still barreling their way to a strong performance despite the problems that have beset advanced economies. Perhaps, in a long-term structural sense, they are becoming less dependent on advanced economies.

SHORT-TERM RISKS

We are certainly not out of the woods yet and a number of risks could well stall the recovery, which is far from entrenched or robust.

Weak consumer confidence and minimal employment growth could dampen the recovery if they translate into tepid growth in private consumption. Rising inflationary pressures in some emerging markets may lead to a tightening of monetary policies that would tone down growth in those economies.

Financial markets in many advanced economies are still in perilous shape, with the European debt crisis creating concerns that some European banks have significant exposure to sovereign debt of countries in dire fiscal straits. In other advanced economies such as the U.K. and the U.S., uncertainty about the impending changes to the regulatory landscape and the macro environment are causing financial institutions to conserve capital and limit credit growth. This could hold back both investment and private consumption growth.

MEDIUM-TERM RISKS

Rising levels of debt in the advanced economies pose serious risks of macroeconomic and financial stability. According to the IMF, the median ratio of gross public debt to GDP for advanced economies has risen from 44 percent in 2007 to 71 percent in 2010, and is likely to rise to 76 percent by 2015. The corresponding numbers for emerging markets for those three years are 32 percent, 39 percent and 39 percent, respectively. These high and rising debt levels of advanced economies will soak up a lot of world savings, reduce global potential output growth, and create a risk of inflationary spirals in the future.

There is also a risk of resurgent global imbalances, with many features of the world economy resembling the situation in 2006-07. Large and rising government budget deficits in the U.S. and many other advanced economies, along with low rates of private saving, are likely to lead to an expansion of current account deficits in these countries. Despite its rising deficits, however, the U.S. dollar's position as a safe haven currency has been strengthened by the problems in Europe, leading to large capital inflows and low interest rates in the U.S.

The combination of low interest rates in the U.S. and weak growth prospects of other advanced economies has led to a surge of private capital inflows to dynamic emerging economies, which are intervening heavily in foreign exchange markets in order to moderate currency appreciation. The resulting buildup of foreign exchange reserves is being recycled in the form of official purchases of U.S. Treasuries, thereby perpetuating imbalances.

While emerging markets have grown strongly, they are not large enough to become drivers of world consumption growth. In tandem with the continued export dependence of China, as well as large advanced economies like Germany and Japan, this portends significant trade tensions in the years ahead, particularly if employment growth remains weak in the U.S. and other major economies.

THE AGENDA FOR G-20 LEADERS

There is a deep tension now between measures to sustain the recovery and measures to bring public deficits and other byproducts of stimulus under control. G-20 leaders, especially those of advanced economies, need to display at least half as much alacrity in designing exit policies as they did in aggressively using fiscal and monetary stimulus to pull their economies back from the brink of cataclysm during the crisis. For advanced economies, the key priority is to develop clear and credible plans to bring deficits under control over the medium term, which would forestall the need to take drastic up-front measures that could put the recovery on hold.

Achieving more balanced global growth also requires addressing Chinese currency policy and implementing structural reforms in China and other countries such as Germany and Japan that are still heavily dependent on exports and need to shift more toward growth led by domestic consumption. The current efforts on financial regulatory reforms need to be concluded quickly both at the national and global levels so that financial institutions can face more certainty about the new regulatory environment, adapt to the changes and increase lending that is essential to support economic activity.

Reform of the global monetary system has taken a back-seat, with the dollar's position as the global reserve currency paradoxically being strengthened even as the U.S. runs up eye-popping levels of debt. Now that global imbalances are likely to rear their head again, G-20 leaders should refocus their energies on reform of the international financial institutions to provide more effective global surveillance and a platform for coordinating policies to prevent these imbalances from posing a new threat to economic and financial stability.

G-20 leaders have their task cut out for them when they meet in Toronto. They must rise above platitudes and petty politics to put the world economy back on track toward balanced, robust and sustainable growth.