The World Economy: Bottoming Out or a Respite before the Next Crunch

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In early 2009, the world economy seemed to be headed into an irreversible decline. But a strong dose of stimulative monetary and fiscal policies—perhaps with an assist from the natural resilience of the market economy—seem to have done the trick in stabilizing the financial system and setting the stage for global recovery. Flows of private capital to emerging markets have revived and world trade has begun to rise back to levels seen before the crisis hit. Consumer and business confidence are back on the rise.

While the overall sense of doom has been replaced by one of hope, the recovery has been highly uneven. The U.S. economy, which was at the epicenter of the crisis, still faces a long hard slog in returning to decent growth. The continental European economies, especially France and Germany, have bounced back with surprising alacrity but are unlikely to record high growth. The emerging markets are another story altogether, with China and India in particular returning to remarkably high growth rates after their economies had seemed to hit the wall at the end of 2008. Many other emerging market economies that were hit hard by the crisis, especially those in Eastern Europe, are still in the doldrums.

This leaves three questions on the table for policymakers of the Group of 20 countries, the group that has become the de facto

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agenda-setting body for the world economy. What needs to be done in the short run to secure the recovery? What are the medium-term risks that such policy stimulus measures could create? What does all this bode for global macroeconomic and financial stability?

This Is a Recovery?

The global economic recovery is tepid and far from assured. The U.S. economy still faces enormous headwinds, including weaknesses in the commercial real estate sector, a rising unemployment rate, and weak consumer demand. On the plus side, there is still a great deal of stimulus wending its way through the economy, inventory rebuilding has begun and confidence indicators are up. A few other advanced economies are in better shape but domestic demand still remains weak in most of them. While the major emerging markets are growing strongly, they are not capable of pulling in large volumes of net imports from the rest of the world and thereby serving as engines for world growth. Even while industrial production and GDP are beginning to bounce back from their lows, employment growth continues to remain weak even in the fast-growing economies.

Despite all the concerns about the efficacy and dangers of the stimulus measures, withdrawing monetary and fiscal stimulus prematurely is a greater risk at this stage, when economies, markets, and sentiments remain fragile. An important question to ask is whether the measures taken to stanch the crisis might be steering the global economy toward the edge of another cliff.

Global Imbalances

The deep irony is that the recovery is setting the stage for a resurgence of global macroeconomic imbalances, which contributed to getting us here in the first place. While the root causes of the financial system lie in weak regulatory systems and regulatory failures, global imbalances—a consumption binge in the United States and a few other industrial economies financed by excess savings in Asia and other emerging market countries—permitted the problems to fester and blow up in our face. Indeed, as we come out of this crisis, some of the growth patterns are getting entrenched and global imbalances could well bounce back.

China still needs exports to generate jobs and sell the surplus output that is going to result from its investment spurt and that cannot be absorbed by domestic household demand. Large economies like Germany and Japan also remain dependent on exports to power their recoveries. In sum, the rest of the world still seems to be looking to ride the coattails of the United States. This could hold back the U.S. recovery itself and create international trade tensions. Of course, in the United States, private household demand may remain weak in the short term but government spending is more than making up for it, leading to large dissaving at the national level.

From a long-term perspective, emerging markets now have stronger incentives for self-insurance through reserve accumulation. First, emerging markets have seen that even large stocks of foreign exchange reserves can shrink very quickly. For instance, India and Russia lost nearly a fifth of their respective reserves stocks in just a few months at the height of the crisis. Second, even the IMF's expanded resources may not be enough to offset a simultaneous swoon in multiple large emerging markets. In this crisis, even countries that borrowed from the IMF found that accepting IMF conditions attached to those loans did not lead to a surge of private capital inflows. Third, many emerging market politicians see borrowing from the IMF as a toxic proposition—there remains a deep stigma associated with turning up at the IMF's door with a begging bowl.

In short, the conditions may soon be ripe for the crisis that many macroeconomists were more concerned about—a plunge in the value of the dollar that eventually requires a painful macroeconomic adjustment in the United States and the rest of the world. What can be done about this? Not surprisingly, one part of the answer is for each country to do the right thing from both domestic and global perspectives. But this will have to be supplemented with measures to strengthen the international monetary system.

Domestic Reforms

The United States needs to get its fiscal house in order. Given the sheer size of the U.S. economy, high levels of U.S. deficits and debt could create global instability. A deficit of $1.4 trillion (about 10 percent of GDP) in 2009 year followed by an overall deficit of $9 trillion over the next decade suggest that the U.S. government could soak up a lot of U.S. and global savings. This would leave a

lot less for private investment and also indirectly crowd out this investment if the scale of government borrowing drove up interest rates. It is premature for the United States to pull back fiscal stimulus, but a well-articulated plan that lays out a path for restoring fiscal stability is essential.

In China, the bank-financed investment boom may have exacerbated the pattern of investment-led growth that is weak on employment creation. If employment and household income growth do not keep pace with output growth, China could face a situation of simultaneous price deflation and bubbles in asset markets, including real estate and equity markets. The Chinese government has attempted to boost household consumption by strengthening the social safety net, raising public expenditures on health care, and providing incentives to consumers to purchase durables (Chamon and Prasad, 2010). These efforts will take time to bear fruit and may not amount to much if there isn't serious reform of the financial system (including incentives faced by banks) that would allow bank credit to flow to small and medium-sized private enterprises that are more dynamic and could serve as engines of employment growth. Financial sector and other reforms, including a more flexible exchange rate that would allow for a more independent monetary policy, are all important components of this process.

Other major economies, including Japan and the key European countries, have their own long reform agendas, including labor and product market reforms, along with measures to strengthen their financial sectors.

International Reforms

The G20 has taken impressive steps to coordinate global stimulus efforts, make progress on financial regulatory reform, and increase the stability of the global financial system. But the report card is still mixed. For instance, the IMF now has a lot more resources but reforms to give the emerging markets a more significant voice in the institution have come to a grinding halt. In the absence of serious institutional reforms, the emerging markets will be loath to rely on the IMF's largesse. They will, instead, continue to self-insure and do whatever it takes to accumulate reserves.

The G20 has become a useful forum where key emerging markets have a more powerful voice. But there remain major substantive and philosophical rifts among different groups of countries within this

forum. These fault lines could become increasingly apparent now that the worst of the crisis is behind us and various economies are reverting to type. The United States and United Kingdom maintain a healthy Anglo-Saxon respect for market forces while France and Germany lead the continental European economies in wanting to increase the scope and tightness of regulation. The main emerging markets are most concerned about how a new international regulatory framework could be intrusive and push them to a place where they would rather not be in terms of financial development and regulation.

G20 leaders should make a serious attempt to tackle some of these substantive differences frontally rather than papering over them with lofty-sounding sentiments. Reform of the IMF's governance structure is also overdue and the G20 should move beyond baby steps on this front.

The much-touted G20 framework for balanced and sustained growth is certainly a step in the right direction. There are three challenges to making the framework operational: definition of goals, establishment of quantitative criteria, and an enforcement mechanism. All of these pose potential for conflict, with the main G20 countries having very different perspectives on each.

Some countries would like goals to be defined mainly on the basis of policy variables—fiscal balances and regulatory policies—while others think that outcome variables—current account balances—should be included in the framework. Even the definition of policy versus outcome variables is not straightforward. There is unlikely to be agreement on a common set of quantitative criteria for any goals that are agreed upon, such as a current account balance of 3 percent of GDP. There is logic to country-specific targets but this will simply lead to watering down of the targets as each country argues that it is sui generis and tries to justify its deviations from the norm in specific areas.

The most important problem, even if there were to be agreement on goals and criteria, is the absence of an effective mechanism for countries to make a credible commitment to meeting those objectives. Without this, the incentives to cheat are simply too great. The IMF has taken on the role of facilitator for this framework. What is really needed is an effective enforcer with the power to take actions, even if symbolic, against countries that fail to follow through on their commitments. I have proposed a simple

commitment mechanism that the IMF could put in place for this framework—essentially for countries to post SDR bonds that they would forfeit if they do not meet their own policy commitments made under the aegis of the G20 (Prasad 2009). This would be just a symbolic rap on the knuckles for the major economies but the very public symbolism could at least instill some confidence in the commitment mechanism.

Following Through on Promises

Leaders of the G20 need to maintain momentum on reforms. One risk is that memory may prove short, as it often does, and the drive for both domestic and international reforms may be thwarted by domestic political forces in each country as well as the rent-seekers in the financial system who helped precipitate the crisis in the first place.

In addition to the macroeconomic issues discussed above, the G20 must advance critical financial regulatory reform in order to prevent future implosions of the financial system, especially in advanced economies. The risks in some sense are even greater now as there is an inescapable implicit government backing for large financial institutions, which could lead to more risky behavior by these institutions once the dust settles.

The specter of trade protectionism is also beginning to rise up again—the latest China-U.S. spat on trade issues could well be the leading edge of more protectionist measures to come from both sides. Some of these measures are symbolic and amount to political posturing for the benefit of domestic audiences rather than substantive restraints on trade. But they could easily ratchet up into a broader trade war and inflict economic damage on the countries involved. The collateral damage could be broader as an escalating trade war between these two large economies or any others has the potential to disrupt the world trading system and set back the fragile global recovery that has just gotten started. G20 leaders need to redouble their commitment to beat back protectionist impulses, both in words and in deeds.

The financial crisis has clearly shown that there is now a national as well as international dimension to all of these problems and their solutions. We will all swim or sink together.

References

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