The Global Economy's Hidden Weaknesses

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ITHACA – After a tumultuous couple of years, the global economy finally seems to be in recovery mode. But beneath a placid surface of falling inflation and rising overall growth lie considerable inconsistencies, weaknesses, and tensions, reflected in tanking private-sector confidence.
The latest update of the Brookings-Financial Times Tracking Indexes for the Global Economic Recovery (TIGER) shows that, while global growth is gaining momentum, it remains weak, disjointed, and driven largely by the continued strong performance of just one economy: the United States. In fact, though a few economies – especially the US and India – are operating in high gear, most of the advanced economies and many emerging-market economies, including China, are decelerating, hamstrung by rising debt burdens and feckless policymaking.

With the global economy's prospects unclear, political uncertainty gripping many countries, and geopolitical tensions running high, low business and consumer confidence may come as no surprise. But there is a notable disconnect between weak private-sector confidence and both financial conditions (which have improved) and stock-market performance (which has been relatively strong, even in some countries with poor growth prospects).

This disconnect is apparent even in the US, where a soft landing is now in clear view, as inflation falls gradually in a context of falling unemployment and robust domestic demand. Strong wage growth, together with a rising stock market (which portends healthy corporate earnings), augur sustained growth. The US Federal Reserve is well positioned to continue on the path of gradual interest-rate cuts.

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Even so, consumer confidence has deteriorated, reflecting a general dissatisfaction with the state of the US economy – a sentiment that will play a key role in next month's presidential election. There are also acute risks on the horizon, particularly America's rising public debt – which both candidates' policy agendas would make worse – that could threaten macroeconomic stability.

Other advanced economies are having a harder time. While some southern European countries, such as Spain and Greece, have managed to pick up a bit of steam, the core eurozone economies are languishing. Germany is bogged down by high energy costs, creaky industrial infrastructure, stagnant productivity, and rising export competition from China, while France faces severe fiscal problems that portend further economic and political instability. Amid lackluster growth and falling inflation, the European Central Bank has had little choice but to continue cutting rates, even though services inflation and wage growth remain persistently high.

The United Kingdom, for its part, seems to have gained some economic traction – thanks not least to monetary loosening – but business investment continues to decline, productivity growth remains anemic, and fiscal risks loom large. As for Japan, its central bank has broken with its peers, raising interest rates to prop up the yen and stem rising inflation, but this will do little to encourage household consumption.

Even China – long the global economy's main growth engine – is floundering. To be sure, a new round of monetary and fiscal stimulus, together with measures to bolster property prices and strengthen commercial banks' balance sheets, promise to give a boost to the real-estate and equity markets. But the policies that have been announced so far will likely prove insufficient to overcome deflationary pressures arising from weak domestic demand. Private-sector confidence has taken a severe beating in recent years – owing largely to a lack of clear policy direction from the government – and this has undermined household consumption and business investment.

To get its economy back on track, China will have to introduce a new set of well-targeted fiscal-policy measures, including income support for households, tax cuts, and a restructuring of fiscal relations between the central government and local authorities. At the same time, the government must pursue deeper structural reforms aimed at reviving productivity growth and restoring business confidence – no easy feat.

India has emerged as a bright spot in the global economy. Thanks to strong infrastructure investment and the rapid expansion of high-value-added manufacturing and services sectors, growth has been robust. Increased consumer spending and healthy bank balance sheets have countered the headwinds arising from still-high inflation and weak agricultural-sector performance, while prudent monetary and fiscal policy have bolstered financial markets.

Moreover, India stands to benefit from two global trends: the decline in global interest rates could stimulate capital flows into the country, and the drive by many major economies to shift supply chains away from China could lead to higher investment in, and exports from, India. Nearby Indonesia is also proving to be a steady performer, thanks partly to a strong policy framework that appeals to foreign investors.

In Latin America, while Brazil and Mexico appear on track to record healthy growth, many other countries are grappling with large budget deficits, unsustainable debt burdens, exchange-rate volatility, and falling demand from China, one of the region's leading export markets. Meanwhile, though Russia's economy and financial markets have withstood Western sanctions reasonably well, the war against Ukraine will diminish the country's long-term growth potential.

The relative calm that has taken hold in the global economy gives policymakers around the world an opportunity to tackle underlying obstacles to growth. This means bringing public finances under control, fostering household and business confidence, and devising clear policy frameworks to boost productivity growth. Concrete steps to improve the functioning of labor, product, and financial markets are essential.

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