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Why the global economic recovery is in trouble

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The world economy has hit a rough patch on the road to recovery and is in danger of skidding off course.

The latest update of the Brookings Institution-FT Tracking Indices for the Global Economic Recovery (TIGER) reveals abundant cause for gloom. The general picture among G20 economies is one of slowing growth, swooning financial markets, and declining consumer and business confidence.

A series of adverse shocks, coupled with political wrangling that has stymied effective policymaking and added to uncertainty, has crippled growth in advanced economies. Emerging markets have maintained strong growth so far, but the battle against domestic inflation and weaknesses in major export markets are beginning to affect their growth as well.

Debt crises, weak employment growth and policy dithering in the major advanced economies have exacerbated global economic uncertainty. The perception of rising risk and inadequate policy responses has shaken financial markets and dented confidence around the world. Reflecting widespread anxiety and fear about global economic prospects and the lack of obvious policy solutions, stock markets around the world have taken a beating over the past summer.

The US recovery has been hurt by a withdrawal of fiscal stimulus in the short run and little decisive action in tackling the long-term debt problem, exactly the opposite of what's needed. Political wrangling and weak employment growth have contributed to declines in business and consumer confidence, with these factors feeding off one another and stunting the recovery. Economic activity has lost momentum, with growth in GDP and industrial production slowing down.

Japan is still reeling from the aftermath of the earthquake and tsunami, with political instability contributing to a lethargic economy that is unable to shake off its torpor. Most macroeconomic indicators—including GDP, employment and exports—are weak and show little sign of recovering anytime soon.

The German economy has held up well and continues to be an export machine. However, employment growth has leveled off and the European debt crisis appears to be hurting consumer and business confidence, which does not bode well for continued strong growth.
Other advanced economies face varying degrees of economic distress. It is difficult to find grounds for optimism about strong growth prospects in any of these economies. Even in commodity-exporting countries like Australia and Canada, whose fortunes are increasingly tied to those of major emerging markets, growth is slowing down.

Emerging markets continue to perform well but remain under pressure, with concerns about persistently high inflation and, in some cases, frothy asset markets. The challenge for these economies is to maintain high growth while tamping down inflation, a difficult proposition even in good times and particularly so when the advanced economies are dragging down global growth and adding to emerging markets' policy complications.

China's economy continues to forge ahead, with GDP and industrial production still growing strongly and robust domestic demand offsetting a decline in export demand. There are signs of increasing domestic policy tensions as concerns about high inflation square off against the desire to maintain strong domestic growth. Monetary tightening has moderated the pace of credit growth but it still remains a source of concern. The odds are about evenly balanced between a soft and hard landing, with global economic conditions being the wildcard.

India's financial markets have cooled off and GDP growth has slowed slightly, but foreign trade and industrial output continue to grow strongly. In Brazil, GDP and industrial production growth have both weakened. In these and many other emerging markets, continued strong credit growth even as confidence indexes are weakening indicates a major challenge for policymakers in maintaining strong growth while keeping inflation bottled up.
Emerging markets may find it difficult to continue being the drivers of global growth for much longer if advanced economies' policies fail to restore their own economic growth and, instead, just add to global financial instability.

Meanwhile, advanced economies' policy options are being hemmed in by economic and political circumstances. Fiscal policy is constrained by crushing debt burdens and monetary policy is reaching its limits, with further unconventional monetary easing likely to yield a low ratio of reward to risk. Advanced economy central banks have already expanded their balance sheets massively in ways that carry many economic and political risks.

The world economy is entering a difficult and dangerous phase, where there are no easy or costless policy solutions but policy paralysis also carries enormous risks of unraveling the feeble recovery.

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