ASSESSING THE GLOBAL ECONOMY AND SUPPORTING THE RECOVERY AT SEOUL

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Framing the Issues

The global economy has lost momentum and is teetering between a slowdown and at best a tepid recovery. Advanced economies are stuck in a funk and even the dynamic emerging markets have lost some of their swagger. In Seoul, G-20 leaders will need to address the issues surrounding the growing dichotomy between emerging markets and advanced economies in terms of macroeconomic prospects as well as policy space.

In most emerging markets, growth has rebounded strongly after the crisis and there are concerns about equity market and real estate booms, with rising inflationary pressures in a number of them. Among advanced economies—with Germany as a notable exception—output growth has been modest at best, job growth has been weak and unemployment has stayed high. Policy stances will therefore have to be very different across the two groups of economies.

The Global Recovery and Policy Considerations

Financial markets took a beating in 2010 Q2 roughly around the initial period of the European debt crisis and continued to weaken through 2010 Q3. This correction appeared to signal a reversal of the optimism that led to equity markets getting ahead—perhaps too far ahead—of improvements in real economic activity. Equity markets have rebounded in the most recent quarter, with an especially strong rebound in emerging markets where capital inflows have played an important role in boosting equity values. Many emerging markets are attributing the latest influx of capital inflows to policies of monetary easing and increased money supplies in advanced economies.

Real economic activity has eased up after initially surging from the low levels around the trough of the global recession in late 2008. Real GDP growth has not done too badly, especially among emerging markets, but growth in industrial production, exports and imports have all dipped across the board over the last two quarters. Employment growth in the advanced economies also remains weak. If the negative trends in these variables persist, real GDP growth might moderate in the next couple of quarters, adding more headache to a G-20 priority of coordinated stimulative and contractionary macroeconomic policies between advanced economies and emerging markets.

Among G-20 economies, consumer and business confidence have leveled off from their gains earlier this year. Even though business confidence is still rising in advanced economies, it has not yet made up the ground lost during the crisis, and consumer confidence has entirely lost momentum. Consumer confidence has dipped sharply in the U.S. and many emerging markets, which could portend a slowdown in domestic demand growth for such economies — an important consideration in the context of global rebalancing.

The rather bleak global picture is reinforced when examining trends in specific countries. In the United States, real economic activity has held up reasonably well, driven by decent and sustained industrial production growth, and continued growth in imports and exports. Employment growth continues to improve relative to the trough, although it's still barely in positive territory. But both business and consumer confidence have eased off, another sign that domestic demand may not be making a strong comeback anytime soon.

Germany is one relatively bright spot amidst the gloom. Its industrial production growth has stayed strong, as have growth rates of exports and imports. Consumer and business confidence are also continuing to rise. Consequently, while Germany has also been beset by weaknesses in equity markets, its overall economic activity has stabilized.

China and India continue to barrel along although their red hot pace of growth is showing some signs of cooling off. In China, industrial production growth and trade growth have moderated, business and consumer confidence have stagnated, and equity markets had fallen sharply before flattening out in recent weeks – signs that Beijing may not make any changes in the near term on its exchange rate policy.

A common feature among G-20 economies is that their financial systems, characterized by poor performance of equities and weak credit growth until recently, are not providing much support to the real economy. Weak financial markets and lackluster employment growth have dented consumer and business confidence, which could hold back the recovery in aggregate demand in advanced economies.

Financial market sentiment around the world appears fragile due to concerns that macroeconomic policy tools may have reached their limits in terms of supporting economic growth without creating untenable risks for the future. Uncertainty about the regulatory landscape may also be restraining financial market performance, although some of this uncertainty should now have been resolved by the Basel III accord.

Action Items for the G-20

Short-term stimulative policies in advanced economies are generating enormous risks over the longer term, especially with rising levels of public debt and aggressive monetary easing in many countries. While the recovery in advanced economies clearly needs support from macroeconomic policies in the short run, it is important that G-20 leaders in Seoul prioritize the development of credible medium-term plans for withdrawing monetary stimulus and putting debt on a more sustainable trajectory.

Most emerging markets need fiscal and monetary tightening--which could partly be accomplished by allowing for currency appreciation—to cool off asset market booms that could eventually turn into busts.

The difficult jobs picture is a common theme across G-20 countries and is in large part responsible for the specter of currency wars as countries try to maintain the competitiveness of their export sectors, which tend to be good at generating jobs. It is encouraging that G-20 finance ministers pledged at their recent meeting in Gyeongju to foreswear competitive currency devaluations and explicit protectionist policies. But this still remains a risk to be guarded against, given the domestic political pressures building up in each country as unemployment remains stubbornly high and job creation remains lackluster. A reaffirmed commitment at the G-20 Summit in Seoul to avoid competitive currency devaluations would help further strengthen the encouraging pledge made by G-20 finance ministers in October.

All told, the optimism of the summer is giving way to the realization that a balanced global economic recovery is going to be a long and hard slog. The G-20 objective of robust, balanced and sustainable growth remains a chimera for now.