Introduction: New Challenges for the Global Economy, New Uncertainties for the G-20

Kemal Derviş
Vice President, Global Economy and Development, The Brookings Institution; Former Executive Head of the United Nations Development Program; Former Secretary of Treasury and Economy Minister; The Republic of Turkey; Advisor, Istanbul Policy Center

Homi Kharas
Senior Fellow and Deputy Director, Global Economy and Development, The Brookings Institution; Former Chief Economist, East Asia, World Bank

Strengthened Hopes

As G-20 leaders prepare for their seventh meeting in Los Cabos, Mexico, strengthened hopes are struggling against renewed fears in the world economy.

The stronger hopes are due primarily to the more rapid output and employment growth in the U.S. economy that have come in better than expected in late 2011. It now appears possible that GDP in the United States might grow at a rate close to 2.5 percent in 2012, compared to 1.7 percent in 2011. Moreover, for several months, job creation has exceeded new entries into the labor force, reducing unemployment to well below 9 percent for the first time since the employment plunge in 2009. While this is modest progress compared to the challenge ahead— it would take almost a decade to reduce unemployment to pre-crisis levels at the pace of recent months— it has triggered a significant stock market surge, reinforcing a positive dynamic in the U.S. economy.

There also is considerable uncertainty in the outlook for Europe with median forecasts suggesting another year of zero growth. The long awaited deep Greek private debt restructuring finally took place without the catastrophic effects that some who had argued against it had forecast. The European Central Bank provided ample medium-term liquidity to the banking system, calming markets and providing time for greater structural adjustments. A decision to augment the size of the eurozone’s financial firewall was finally taken in late March. The latter involves a temporary enlargement of the eurozone bailout system to €700 billion by setting up the new bailout fund, called European Stability Mechanism (ESM) with a permanent €500 billion in capacity, but allowing the €200 billion from the European Financial Stability Fund already committed to Greece, Ireland and Portugal, to be set aside and not be folded into the ESM as originally planned.

Growth in the emerging and developing countries has slowed, but still continues at a robust pace, with their internal growth dynamics playing an increased role compared to their exports to the advanced world.

A surge in oil prices at the start of the year, linked partly at least to political uncertainties surrounding Iran and security of supply in the Gulf, signaled a new danger in the early months of 2012. A massive surge in oil prices remains a short-term threat for the world economy, but at time of writing this threat seems to have moderated, notably because of the strong resolve of Saudi Arabia to stabilize prices, although this resolve would not be of much help if there were serious disruptions of supply routes.

Renewed Fears

Despite the mixed news summarized above, we believe that there remain very serious downside risks and long-term difficulties for rapid and balanced growth of output and employment in the world economy. While there are some risks and reasons to fear everywhere, the most serious systemic risks are linked to problems in the eurozone and, notwithstanding recent progress, in the United States.

The eurozone remains a key concern. The massive provision of liquidity to the banking system by the
ECB has been crucial in overcoming the immediate crisis that threatened in late 2011, but it cannot by itself lead to healthier and better capitalized financial institutions. For that, serious restructuring and additional capital is needed. Time has been gained, but that time needs to be used to solve the underlying problems of the banking sector. With regard to the ratios of sovereign debt to GDP, the fear is that the contractions in GDP that could be caused by too severe austerity measures would frustrate the attempts to reduce indebtedness ratios by very restrictive fiscal policies. So both the banking sector’s problems and the high debt problems remain unsolved for a number of countries.

Perhaps even more intractable than the banking sector and national fiscal problems may be the internal imbalance problem within the eurozone, within which cost structures have diverged and where some countries have lost competitiveness to an extent severely constraining their growth prospects. It is reasonably clear that the equivalent of a real devaluation is needed, but it cannot take place with the help of nominal exchange rate adjustments in a monetary union. So it must take place through “internal” price and wage level adjustments. This is extremely painful and difficult, particularly if the adjustment burden is put entirely on the “deficit” countries, as has so far tended to be the case. A real debate is now underway in Europe as to the economic and political “realism” of current policies. The search should be for the narrow limits of the possible between too much austerity imposed on, broadly speaking, the “South”, that could lead to socioeconomic “growth collapse”, and too little long-term fiscal adjustment paving the way to renewed crisis.

This debate is being shaped by a rapidly changing political climate in Europe. In Greece, France, the Netherlands and Germany, election results and coalition politics appear to be showing the strains of sustaining austerity programs. A new discussion of innovation and productivity growth is occurring, but against a backdrop of uncertainty over the ability of politicians to implement and sustain long-term programs. These predominant concerns about Europe seem to have distracted attention from the very serious fiscal and long-term structural challenges that remain in the United States. The recent uptick in growth still appears to owe too much to extremely expansionary monetary and fiscal policies that will be hard to sustain. The private sector deleveraging process has made some progress but is far from completed. Fixed investment remains low despite large corporate profits and the availability of finance. The problem seems to be uncertainty, both about future demand and about future policies. With income gains accruing almost exclusively to those at the very top of the income distribution, it is far from clear what the source of broad based sustainable private demand expansion is going to be. And the uncertainty about future policies has been accentuated by the polarization of the political process and the very different approach taken by the two main political parties in the United States. It is true that bond markets continue to signal a lack of concern, but history as well as the European experience should lead to caution: markets can move very rapidly, and while the Federal Reserve has formidable restraining tools, it could not keep longer-term interest rates down in the face of a severe loss of confidence. The United States is on an unsustainable path in terms of the combination of tax revenues and government expenditures. Many avenues for reform are possible and the different policy packages proposed reflect the interests and political philosophies of the different groups. What is not sustainable, however, is a prolonged stalemate. Unfortunately this is exactly what the political system has offered over the last few years.

Twenty-twelve is of course an election year. The outcome will have huge importance not only for the United States itself, but for the world as a whole. The share of the United States in world output has diminished, but it remains by far the single largest economy, and slow growth or the absence of growth in the United States would be a powerful constraint on the world economy. The policy debate in the United States is therefore of global concern. We have been very lucky that as the problems in the eurozone took center stage, the U.S.
economy started improving; if that had not been the case, the world economy would be facing a more severe slowdown.

There are of course other risks in the world economy that do not have their primary source in the U.S. or Europe. We have already referred to the risk that a surge in oil prices could constitute. A major slowdown in China, perhaps triggered by retrenchment in the real estate sector, would be a severe blow to the world economy.

The policy debates in Europe and the U.S. are hugely important, not only for their immediate impact on the national and global economies. They also reflect deep disagreements among economic theorists and the difficult search for a post-crisis framework of analysis. And they reflect the big dilemma of globalization: how can national democratic processes and election campaigns, rooted in the very local, lead to economic decision-making that takes into account our increasing global interdependence?

Challenges for the G-20

Perhaps the most crucial contribution the G-20 process can make is to help bridge the gap between the national and the global, in full cooperation with the existing global international institutions, as well as engaging the world of academia, civil society and think tanks. There will be several new faces at the Los Cabos G-20 Summit, as well as new domestic political landscapes for many leaders. The G-20 is an opportunity to connect their concerns with global approaches. The atmosphere of finger pointing at others as the source of the world’s problems can be offset by thoughtful communication about globally coherent solutions. This Think Tank 20 (TT-20) collection of essays aims to be a modest contribution to this effort. In the papers in this volume, three themes emerge clearly. First, many authors, especially those from developing countries, write about their own countries’ past experiences with sovereign debt and banking crises. This is a salutary reminder that the problems now being faced in Southern Europe are not entirely new, although the common currency poses a very specific challenge. There is much to learn from economic history, and the peer review function that the G-20 performs can be very valuable.

At the same time, crises can deflect attention from long-term issues. The second theme emerging from this collection is that the new discussion on growth and innovation must be centered on a long-term vision of how to build and implement a low-carbon, energy-efficient growth model. That is a collective action, long-term endeavor for all the G-20 countries, but it is currently being pursued as a series of individual country efforts.

The third theme of this collection is that the G-20 is struggling to be a relevant process. Europe is leading the way in deliberations about problems on that continent and making its own mistakes along the way, despite the large externalities imposed on the rest of the world. A greater G-20 input would be desirable. Outside of financial stability, the G-20 has not articulated a view of long-term, sustainable and balanced growth in a way that helps advance national dialogues in a globally coherent way. There is a growing risk of beggar-thy-neighbor policies (through exchange rates, monetary policy, regulatory arbitrage and other means) as each country tries to gain an advantage in the current crisis. Addressing these considerable challenges is no easy task at a time when there are new faces among G-20 leaders and new domestic political challenges in many G-20 countries.