THE G-20 AND THE WORLD ECONOMY: SINK OR SWIM

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FRAMING THE ISSUE

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 been revived and world trade has begun to rise back to levels seen before the crisis hit. Consumer and business confidence is 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While the overall sense of doom has been replaced by one of hope, the recovery has been highly uneven.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 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 the Pittsburgh G-20 Summit: What needs to be done in the short run to secure the recovery? What are the medium-term risks that the world economy faces? What does all this bode for global macroeconomic and financial stability?

POLICY CONSIDERATIONS

Economic 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 U.S. 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 U.S. This could hold back the U.S. recovery itself and create trade tensions. Of course, in the U.S., 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. 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 U.S. 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. But this will have to be supplemented with measures to strengthen the international monetary system.

Domestic Reforms

The U.S. 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. Recent official estimates of a deficit of $1.6 trillion (11.2 percent of GDP) this 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 U.S. 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 healthcare, and providing incentives to consumers to purchase durables. 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 G-20 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 reluctant to rely on the IMF. Instead, they will continue to self-insure and do whatever it takes to accumulate reserves.

The G-20 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 U.S. and the U.K. 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 frame-

work could be intrusive and push them to a place where they would rather not be in terms of financial development and regulation.

G-20 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 G-20 should move beyond baby steps on this front.

ACTION ITEMS FOR THE G-20 SUMMIT

Leaders of the G-20 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 politics 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 G-20 must advance critical financial regulatory reform in order to prevent future implosions of the financial system, especially in advanced economies. G-20 leaders need to redouble their commitment to beat back protectionist impulses, not just in words but also in deeds.

The financial crisis has clearly shown the world is very interconnected—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.