The World under the New G-4 (and the Rest of Us)

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Time flies. Since the onset of the Great Recession, the global economy has been through a rollercoaster, more so in terms of shifting expectations and perceptions than in terms of actual growth trajectory (although a full recovery failed to materialize, many countries are more than muddling through). Policy makers likely underestimated the complexity and dangers of bringing highly leveraged economies (governments and families) to a new normal; nonetheless, governments and their central banks were able to stabilize their economies and bring a modicum of predictability in the context of fractured markets and agents herding into panic.

Yet, past is the time when the discussion centered on the alphabet soup-nature of the recovery—if in V, W, L or some other geometry. At today's juncture, as we approach the fifth anniversary of the Great Recession, the degree of uncertainty regarding the future path of the world economy is in many ways as great as when the economic maelstrom began. We are moving into the unchartered waters of reversing the ultra-monetarist policies of the Fed and the credit expansion which took hold under the shadow of People's Bank of China (PBoC) while Europe is in recession and Japan plays in a delayed mode, its own and extreme version of quantitative easing.

Future prosperity seems to be now resting first (and possibly foremost) on the U.S. recovery, which appears to be a bit more solid than a year ago. Consumer confidence is rising and so are housing prices—thus improving the state of the real estate market. These are encouraging signs for the two drivers that traditionally held up the economy: consumption and construction. Moreover, lower energy prices with the shale gas boom points—for the first time in decades—to a manufacturing revival that is not only confined to energy-intensive sectors. What we still don't know is how at the end of the day the post-Bernanke Fed will unwind its extraordinary large balance sheet, estimated to reach $4 trillion by mid-2014, without destabilizing the global economy. Are we going to witness a magnified version of the May and June events in reaction to the Bernanke speeches of a sharper strengthening of the dollar, weakening of commodity prices, retrenchment away from emerging markets' sovereign and other bonds, rise in interest rates and once again a bear stock market from financial worries and massive losses of bondholders? Are we only seeing the tip of the iceberg of what is to come? It is sufficient to recall that while central banks were expanding their balance sheets, net private capital inflows to emerging markets amounted to an estimated $4.2 trillion in 2009-2012. Their significant reversal, if long rates abruptly rise again, would be quite catastrophic, meaning lower growth rates, a rise in unemployment, and further cuts in public services.

Europe, in its turn, is at a crossroad. Rigid fiscal policies to regain creditworthiness and certain structural reforms (mostly related to labor markets) imposed by the Troika (The European Commission, the International Monetary Fund and the European Central Bank) have yet to produce the results which were hoped for, and the resumption of growth on a more sustained basis seems to be years away. Political opposition is on the rise against German stubbornness; at the end of the day, if there is no hope that things will eventually improve, no political party or coalition can remain in power, just resting on empty promises.

The fallacy of composition has worked backwards: as most countries in the continent are not growing, consumers are refraining from spending and the world marketplace is ever more competitive. Can countries drive out of a recession through exports, anchored on falling nominal wages (the only possibility to lower labor costs within a monetary union)? Record unemployment among young people and a drastic retrenchment of social services is testing the limits of patience and political resilience across Europe. The relevant question seems to be: Will common sense befall on the German leadership, agreeing not only to a more moderate path of fiscal discipline, but most importantly, for the German economy to steer Europe back to prosperity by way of a fundamental macro-rebalancing? Will German consumers help Europe grow out of recession in the context of public sector and household deleveraging?

It took the European Central Bank (ECB) to credibly commit for the eurozone not to collapse. It is unlikely that Mr. Draghi will go any further this time to stimulate business lending, but the ECB should. Small and medium sized firms from Italy and Spain, the two critical economies of Southern Europe, face an unheard of wedge between ECB rates and what commercial banks are willing to lend, close to triple of pre-crisis levels. Arguably, they are the job-creating machines of those economies. If the world was cruising along and Southern Europe was the odd man out, Germany might be able to step aside as countries coming out of recession with the help of ex-eurozone trade and foreign investment. That not being the case, the eurozone will have to bootstrap itself, or better, Germany and the larger or more solid economies will need to use the Olsonian “logic of collective action” whereby those who have the most to lose from a breakup of a union have a special responsibility towards the more feeble members. In the global arena, Europe is the player, not Germany individually. Is this intelligible to voters? Of course. It must be first intelligible to leaders, which is not self-evident.

Third, the Chinese enigma continues to baffle policymakers and analysts alike. Most are still betting (hoping?) that the Chinese leadership and the State apparatus will be able to steer the country to a more sustainable consumption-driven growth trajectory where real wages increase, a new wave of rural families find their way into the urban labor market, and a more encompassing social security system is put in place. Yet, the transition will take a toll as a credit induced bubble fueled by shadow (and commercial) banks is reigned in and public enterprises propped up by local and provincial governments are restructured, merged, downsized or eased into exit. This is a tall order and there is no guarantee that China will be able to smoothly converge to an economy which is the mirror image of the past three decades. While factor augmentation and exports take a back seat, innovation and an educated labor force bring rising incomes, create employment opportunities for the middle class, and support a productivity-driven growth trajectory in the coming years, hovering around 7 percent p.a. In late June, markets got the jitters after the PBoC decided to tighten credit conditions in light of the 52 percent growth in domestic lending in the first five months of 2013 (with respect to the same period in 2012). Interest rates shot up with interbank rates reaching a record 13.7 percent before receding (normal levels being in the 3-4 percent range). The world trembled in anticipation of an economic deceleration with vast implications for commodity markets, global trade and stability.

Finally, the ability of Japan to ride out of its inflation-prone economy with the help of an ultra-monetarist experiment—Abeconomics—is in question. It is true that initial results looked promising: while the wealth effect from the stock market rise helped to push up consumer spending, the yen devaluation helped exporters, and both boosted firms’ profits and investors’ confidence. Yet, is this enough? Mr. Abe thinks not, but structural changes in a very conservative society come slowly, if at all (such is the case of a genre-related aggiornamento in the labor market being pushed by the government, which could bring a welcomed boost in demographics to long-term growth). How long will the initial positive effects last? It seems that the prime minister envisions a stopgap

solution that will last long enough while Japan waits for the world economy to recover.

In all four instances, central banks and their monetary policies seem to have achieved a new prominence. They are more than the guardians of the domestic or jurisdictional currency, lenders of last resort, and the entities entrusted with keeping credit channels open and financial markets functioning. They have become the global growth and stability insurer with a short-and medium-term policy premium over which there are widely divergent views. Some consider it negligible, others far from it, that we will pay in terms of both asset inflation and, when monetary and credit expansion are finally reversed, price collapses which might destabilize and then throw the world economy back into recession. As in many economics propositions, this one cannot be tested except with the benefit of hindsight.

Yet the newfound prominence of the combined power of the four central banks effectively brings to fore a somewhat uncomfortable fact that at least for the time, it is *this* G-4 which really counts. When they sneeze, the world catches a cold. China and the U.S. may soon start to sneeze in unison as they tighten monetary policy. The PBoC is tightening to deflate a credit bubble while the Fed moves to a still-to-be-defined new age of monetary moderation, to the extent that U.S. labor market conditions allow. In this context, many hope that Japan will stay the course with its monetary expansion and that the ECB will stand fast not only for European financial stability but to compensate in part for the ongoing fiscal restraint which will likely be a drag on growth for the foreseeable future.

Hopes for greater coordination among the major economies seem to be on the wane. It is not so much a case of beggar thy neighbor as it is a case of "ignore your neighbor". In some farcical twist, history is repeating itself. The dominant economies are leaving the rest behind, this time not in terms of income per capita or some other metric of economic wealth, but in the more crude sense that there is an unspoken political imperative for each country to look after their own navel, at least for the time being.

What is the rest of the world supposed to do? Straight talk would suggest that countries do their homework and avoid committing "old mistakes" while taking care of their own business. This, of course, is neither a call for egotistic policies nor for the end of regional alliances, trade or otherwise, but for economic pragmatism. It is also a call for the end of illusions. Emerging economies remain important, but at the end of the day they are less relevant than many expect. Bringing odd couples together to impress global audiences or attempting to mould groups on the basis of ideological likeness has now become, in all probability, a deadweight loss when it comes to the improvement of people's welfare.

Some corollaries follow. Emerging consensus on new economic policies, just as the old ones, should be taken with a grain of salt. The fact is that each country is different, and despite useful lessons that can be gleaned from other countries experiences, with or without the help of multilaterals, their specificities tend to dominate. Thus, policymakers in countries facing low growth are now caught in a firefight among those advocating greater fiscal impulse, those keen on expansionary monetary policies to promote nominal (and hopefully real) growth, and those wanting both or neither. This cannot be answered in abstract, and much less using the unexpected umbrella of a newly found realism or heterodoxy from the IMF and other good souls which seem to be saying: "Yes, loosening up monetary and fiscal policies is acceptable under the present circumstances. Low growth is not conducive to a sustainable fiscal balance and debt dynamics. We have been wrong."

Well, they *have* been wrong, but two wrongs don't make one right. Thus, in one of the significant emerging economies, authorities are finding out the hard way that a concept called potential output, no matter how complicated it is to calculate with a certain degree of precision, is indeed a real concept, with real consequences. A combination of loose monetary policy, expansionary fiscal policies, and rising wages with ample credit to top it off, do eventually lead to inflation, as Brazil is

recently experiencing. Price controls as a means to repress inflation momentarily, without any concept of transition away from such a mechanism, is just a bad idea and it will most probably haunt the economy sooner or later. By the same token, policymakers are also becoming aware that certain macroeconomic identities are unlikely to bend. A low commitment to fiscal responsibility has further impaired the domestic savings-investment imbalance in Brazil, the ultimate culprit of currency appreciation and current account deficits (which are again growing as the savings gap stands at a record 3.2 percent of GDP in May and is projected to reach 3.6 percent in 2013, and over 4.0 percent in 2014). The political economy of protectionism and policy favoritism functions in such a way that the more you feed the hydra, the greater the demand for a Hicksian "easy life". Protectionism and the like do as much harm today as they have done in the past, helping to further entrench conservative interests and solidify resource misallocation while keeping prices high and productivity low.

Finally, the Brazilian government is realizing that the public demands quality public services delivered by a more efficient state. The 2014 FIFA World Cup, an enormously expensive proposition, with waste and corruption to feed politicians, contractors, international soccer bureaucrats *et caterva*, stands in contrast to the quality of public health, education and the mobility crisis in Brazilian metropolitan cities. It was the cost and time spent on public transportation that helped motivate the people to take to the streets.

When the younger generation, more informed and connected with the help of social media than all preceding generations, unexpectedly began to demonstrate in June, they shook the country. They were not afraid to take on the establishment, comprised of a very broad social democratic coalition that grew old and out of touch, and a government that has overseen a dramatic deterioration of the quality of economic policy making, the integrity of fiscal accounts, and the previous autonomy of the Central Bank. Under the pretext that the world (and the IMF) is now acknowledging the importance of countercyclical policies, as shown by recent dramatic experiences in Europe, the Brazilian government did not hesitate to accelerate expenditures and nudge the Central Bank to a more lenient posture with respect to inflation.

Now in mid-2013, after the June events, a reverse course appears to be in the making. The government seems to be again committed to a low inflation regime, even in the face of not too brilliant growth prospects, leaving the Central Bank to use monetary policy as needed and manage the exchange rate with a view of softening volatility, with no specific level guidance. Second thoughts on the economic and political cost of protectionism and highly targeted (and fragmented) industrial policies are leading to a policy reassessment on their effectiveness as growth-inducing devices and on the perception of favoritism. The government is again stressing the importance of (moderate) fiscal discipline insofar as fiscal largesse is not a panacea for an anemic growth rate. The political establishment has been shaken out of complacency, with political corruption under the close inspection of an aggressive (and generally independent) media. In many ways, democracy is (very) alive and well in Brazil.

In this context, the message the streets sent in June was quite clear: honesty and efficiency in government has nothing to do with ideology, and crony capitalism and political corruption are ugly twins that are not to be condoned or explained away by some notion of institutional and political normalcy. The talk of currency wars, continental leadership or BRICS' financial muscle to be flexed around a new development bank carries very little sway when far closer issues to home are the pressing ones, now and in the coming years. This is obviously not a call for the country to turn inwards and abrogate its legitimate role in international institutions and fora, but to recognize that in very few issues of global nature, the country has a relevant say and an ability to act. It has the potential to be an effective regional peacemaker under the auspices of the United Nations as evidenced by the Haiti experience, to act in climate change with a credible commitment to contain deforestation and

the emission of greenhouse gases, in food security with the country's leadership in tropical agriculture, and in global trade with the election of a Brazilian to lead the WTO, especially if trade liberalization returns to the presidential agenda.

In global macroeconomics, Brazil, and practically all countries, is on the receiving end. Time and energy should be allocated to more fruitful tasks other than attempting to influence policies which are set beyond international meetings, no matter how prestigious and well attended. These countries should be taking care of their own economies because the G-4 will not do it for them. For the time being, at least, the new G-4 will be in the commanding heights and we may be observers at best. So, the old prescription is still valid that middle-income countries need to continuously attend to their macroeconomic fundamentals to develop markets and invest in people, to search for ways to differentiate themselves to become attractive destinations, and to ensure that the state is able to effectively and honestly deliver the collective goods and services which people expect. Health, education, safety and urban mobility are among the most critical on a cost-efficient basis, and within a price-stable and predictable environment for business (and jobs) to flourish. In so doing, governments will be responding to the public interest and the legitimate aspirations of their people.