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The Pathfinder Economic Alert

The Global Economic Landscape: Some Reflections

Introduction

Growth has stalled in the global economy. Stock markets have plummeted. Risk appetite has declined and there has been a flow of resources to safe havens. The IMF has stated that the world economy has entered its most dangerous phase since the financial crisis of 2008. The ammunition available to policy-makers is much reduced with interest rates at extremely low levels and the scope for expansionary fiscal policy circumscribed by the large stimulus packages already introduced.

The G20 has pledged to do what it takes to preserve financial stability in global markets. Concerted action is necessary to address the financial pressures in advanced countries to prevent a suffocation of the world economy. Policy-makers in the US and Europe are being called upon to achieve a delicate balance between short-term policies to stimulate growth and employment on the one hand and medium to long-term frameworks for fiscal deficit and debt reduction on the other. While an effective policy response is certainly feasible in a technical sense, politics would need to work much more effectively in both the US and Europe to achieve the desired outcomes. The problems are exacerbated by the disjuncture that exists between the immediate action demanded by markets and the much slower pace at which governments work.

The stalling of growth in the US and Europe has been accompanied by a tightening of the policy stance in major emerging economies, particularly China and India, to contain inflationary pressures. However, unlike the advanced countries emerging market economies are still expected to record robust, though somewhat slower, growth in the medium-term.

A seminal study by Rogoff and Rheinhardt has examined financial crises over several centuries. The authors conclude that crises emanating from the banking system, as opposed to those associated with the business cycle last longer and are more severe in their effects. Rogoff and Rheinhardt found that financial crises typically last five to six years (this implies that we are only half way through the present one) rather than the 12-18 months associated with the economic downturns arising from the business cycle. In addition, the peak to trough loss in output and employment is significantly greater. The policy response to financial crises typically requires structural reforms as well as counter-cyclical measures.

In assessing recent developments in the global economy, it is useful to examine briefly the challenges faced by the US, Europe, China and India. These economies are the key determinants of the prospects for the world economy. China and India have been contributing more than half of the growth of the world economy, while the US and Europe are the two largest markets in the world.

USA

In the US, growth has stalled, unemployment has been persistently high, banks are experiencing short-term funding issues, consumer confidence continues to be muted and the housing market remains in the doldrums. Companies are cash–rich. However, they are not investing because they do not see the final demand. Over the last two years, the government has implemented a large fiscal stimulus package and the Federal Reserve has cut its policy rate nearly to zero and has implemented aggressive unorthodox monetary policies (quantitative easing or asset purchase schemes). While US economy showed signs of recovery, in 2010, growth has now stalled and the economy is not generating sufficient employment. Youth unemployment is particularly severe.

President Obama has just announced a second stimulus package designed to create jobs (it has to be approved by Congress) and the Federal Reserve has recently initiated its "twist programme" (purchase of long-term US treasuries to reduce their yields and divert money into riskier assets). The President has also set out the outlines of a medium-term strategy to address the twin problems of deficits and debt. It incorporates tax increases for the wealthy as well as expenditure cuts. The Republicans, who control the House of Representatives, are ideologically opposed to any tax increases despite overwhelming evidence that the rich have done extremely well in recent decades while the middle class has experienced declining real incomes. Until the crisis, the latter were cushioned by increased borrowings enabled by the rising value of their homes. The collapse of the housing market has meant that Americans, for the first time since the Second World War, are confronted with a situation where the majority of young people are likely to be worse off than their parents.

Despite this, the US remains an inherently resilient economy. Its capacity for dynamism and innovation is reflected in its Research & Development spend and the number of patents registered. In addition, it has a relatively young population. This has the capacity to yield a demographic dividend that boosts the growth potential of the economy.

However, the US needs to rediscover the capacity for compromise and bi-partisan politics on key national issues. The gridlock and brinkmanship seen in Congress during the negotiations on the increase in the debt ceiling needs to be overcome. It is to be hoped that the Super Committee (comprising senior Democrats and Republicans from both the Senate and the House of

Representatives) will find a way of reviving the bi-partisan politics that is needed in the interests of both the US and the rest of the world.

If the politics continues to remain destructive, the US is likely to experience a decade or more of economic stagnation (similar to Japan) and high unemployment. This will inevitably have negative consequences for the rest of the world. Growth in emerging markets like China, India and Brazil would not make up for the continued lack of spending on the part of the US consumer. Over the last 20 years, the US consumer has under-written a very benign period for the world economy. If they continue to focus on deleveraging and do not resume spending, the world economy will experience a lower trajectory of growth, with negative implications for all countries.

Europe

The Eurozone debt crisis is arguably the most intractable challenge on the global landscape. A number of observers believe that the very existence of the Euro is under threat. Here again, the problem is more political than economic or financial. The money is available to create a sufficiently large European Financial Stability Facility (bailout fund) which would give comfort to the markets and buy time for countries like Greece, Portugal, Spain and Italy to undertake stabilization measures as well as structural reforms to increase the competitiveness of their economies. In the case of Greece, the rescue package may well require a significant debt write-down, if the country is to restore growth and avoid a downward economic spiral.

However, the politics are complicated. The German tax payer remains extremely reluctant to bailout what it sees as profligacy in Southern Europe. German sentiments are understandable. The costs of reunification (1990) inflicted a massive shock on the German economy and threatened the post-war “German Miracle.” The negative effects were magnified by the fusion of the Deutschmark and the Ostmark at parity, despite the very large differentials in productivity and competitiveness in the former West and East Germany. The Germans experienced a painful adjustment period. The sacrifices they made have now lifted Germany into the position of being the leading exporter in the World. This makes the Germans less understanding of the failure to increase productivity and competitiveness in the Euro zone countries facing financial crises.

However, Germany has also benefited greatly from European integration, especially the expansion to the East. In addition the Euro has given it a weaker currency than it would otherwise have if it still had the Deutschmark. This has been an important determinant of Germany’s export success. It has enjoyed the competitive benefits of an undervalued exchange rate without being accused of currency manipulation. There is, therefore, a strong case for Germany to support restoration of stability in the Eur zone.

It is noteworthy that China has purchased some Italian bonds recently. The EU is now China’s largest export market. Hence, the Chinese have a vested interest in avoiding a highly disruptive breakup of the Euro zone with high economic and political costs. The Germans are also likely to find it more palatable if China and other cash-rich emerging countries share the burden of financing the bailouts in Europe. Additional spending by the surplus countries to support the deficit countries will also assist in addressing the persistent imbalances in the global economy.

There are two dimensions to the Euro zone crisis. First, there is a sovereign debt crisis in the Mediterranean countries. Secondly, banks in rest of Europe are exposed through their holding of the bonds of the crisis-affected countries. French banks are particularly vulnerable. The banking system is, therefore, the channel through which the contagion can spread to the core of Europe.

Bold and decisive action is required from the Euro zone political leadership. The options before them are clear. On the one hand, there can be a breakup of the Euro zone into a smaller entity comprising the stronger economies. The political costs of the breakup of the Euro Zone would be enormous. The instability created can also have a damaging economic and social impact. The other option involves greater fiscal union involving harmonization of fiscal policies. Some have also called for Euro Bonds, backed by all Euro zone countries, particularly Germany, to finance the funding requirements of the Mediterranean economies. In addition, the EFSF should be made larger and more flexible while the ECB should continue its unorthodox monetary policies. Bailout packages alone would be insufficient to resolve the structural problems that underpin the European sovereign debt crisis. This would merely delay the day of reckoning. The countries affected by the crisis need to stabilize their economies and undertake painful structural reforms to increase the competitiveness of there economies. The measures are difficult and painful. The balance of probability is that Europe will muddle through tending to do too little too late because of its inherently complicated and unwieldy decision-making processes. Europe, outside Germany, is likely to experience a prolonged period of sluggish growth and high unemployment, particularly among youth. A large number of people will experience a reduction in their standard of living. This could well trigger widespread social and political unrest.

China

In recent months, Chinese authorities have tightened their policy stance to combat inflationary pressures. It is likely that they have now reached the end of this policy tightening cycle, particularly as external demand has weakened due to the stalling of the recovery in the US and Europe. However, China is still likely to continue to experience robust growth in the medium - term.

A number of structural challenges confront Chinese policy-makers, if they are to sustain the extremely high growth rates of the past and present. These include a rebalancing of the economy from investment to consumption; from external to internal demand; from a focus on the coastal areas and cities to the hinterland and rural areas. The Hu/Wen government has been less reform-oriented than its predecessor. It has been cautious and conservative. However, there are about to be some changes at the highest levels of the Chinese leadership. Some commentators predict that the next generation of leaders, which includes some “Princes” (children of Communist Party leaders), will be reform oriented and more confident about China's role in a rapidly changing world.

A speeding up of in the appreciation of the Yuan and the opening of the capital account are also considered more likely. In addition, a greater focus on increasing domestic demand will generate export opportunities for the rest of the world. It will also assist in addressing the global imbalances which have proved to be a source of instability in the system. China's ageing population is likely to open up opportunities for exporting labour into the country over the long -term.

India

The Reserve Bank of India has increased interest rates several times in an effort to contain inflation. This has moderated growth. However, Indian growth is likely to be resilient and robust in the long-term. The country enjoys two important advantages in this respect. Much of its growth is internally generated. It is less dependent on external demand and FDI for its growth than China. Secondly, unlike China and Europe, India has a young population which can provide a significant demographic dividend in terms of the potential growth rate. The challenge is to provide its people with the necessary education and skills to realize this potential.

Long-term Issues

The global economic centre of gravity is shifting to the East, led by China and India. Asia will continue to make an increasing contribution to the growth of world output and trade. Dr. Razeen Sally, speaking at a Ceylon Chamber of Commerce Seminar, referred to a process of "Divergence and Convergence" i.e. there will be divergence in the growth rates achieved by Asia and USA/Europe as well a convergence in living standards.

Asia has been the region that has benefited most from globalization, particularly the liberalization of trade and the removal of restrictions on FDI. The USA, as the hegemonic power, has played a key role in advancing this agenda. However, the crisis and its aftermath have triggered protectionist pressures in both the US and EU. To date protectionist and restrictive anti-competitive measures have not emerged to any significant extent. However, protectionist pressures, particularly in their non-traditional forms, are likely to persist as adjustment in the advanced countries is going to be a painful and long-drawn out process. As the US is no longer able to play a leadership role, there is a very strong case for Asia, led by China and India, to take the lead in resisting de-globalization. The current context is not conducive for advancing globalization further (the Doha Round has stalled). However, it is in Asia's interest to argue robustly for a standstill.

This raises questions about the leverage Asia has to play this role. China and other Asian countries hold large amounts of US securities and, as mentioned above, China has bought Italian bonds recently. This trend of purchasing European bonds is likely to increase. The cash-rich

Asian countries are well placed to assist the US and Europe to address their debt and deficit crises. (Brazil has recently proposed that emerging economies should do this.) The quid pro quo for this financing should be at least a standstill in relation to the openness of trade and FDI flows.

The rise of China and India is also going to see a dramatic increase in the number of people acquiring middle-class consumption patterns over the next decade. This will exert enormous pressure on resources. It will have implications for food and energy security, as well as for commodity prices in general. In addition there is just a five year window to reach a global climate change agreement limiting CO_2 emissions to a level which ensures that there isn't an increase in global temperatures of more than two degrees. Failure to achieve such an accord is likely to lead to climate catastrophe. The pressure on resources stemming from the rise of China & India is likely to create a new generation of technologies. Environmental technologies are likely to constitute the next technological step-jump in human history. There are those who argue that in the next 15 years environmental technology would play the sane role that information technology has done in the last 15 years.

Implications for Sri Lanka

These developments at the global level have significant implications for Sri Lanka at several levels. These include trade, tourism, remittances, FDI and commercial borrowing. Investors around the world have reduced their risk appetite and western consumers have lost confidence. It is important that a country like Sri Lanka examines how each of the transmission channels, mentioned above, will be affected by global developments.

In the longer term, Sri Lanka needs to take advantage of its very favourable economic geography. It is located in the dynamic Asian region, a mere 20 miles from the fast growing Indian economy. The South Indian sub- region, in particular, constitutes a market of over 250 million people who have enjoyed double digit growth for a number of years. Intra- Asian trade is the most dynamic component of the international trading system. Yet, less than 10 percent of Sri Lanka's exports are directed to India, China and Japan, while 60% go to the sluggish markets of Europe and the US. Sri Lanka's economic geography offers an unprecedented opportunity for accelerating growth through diversification of both export markets and products.

Conclusion

The West is being afflicted by three simultaneous crises: lack of growth and high unemployment; uncertainty regarding the health of the banking system; and a weak housing market. The current crisis is not the usual cyclical downturn. There are difficult structural issues that need to be addressed. Adjustment will be painful and it is likely to trigger social and political unrest. Above all, there is need for bold and decisive political leadership that builds consensus around a vision for the future of US and Europe. This has been in short supply so far. In the short-term, the G20 (at its meeting in October 2011) must demonstrate the level of ambition and coordination that it showed at its London summit, in 2009, to stabilize the world economy

China and India are likely to sustain high growth rates. However, they will not be immune from developments in the US and Europe. The cash-rich Asian countries have a vested interest in supporting orderly adjustment in the West.

Sri Lanka needs to be vigilant about the implications of global developments which will be transmitted to the domestic economy through several channels.

This is the Fourteenth in the series of Economic Alerts issued by the Pathfinder Foundation.

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