Prospects and Challenges for the Global Economy: From Recession to Recovery

Notes for remarks to G20 Seminar on Themes and Priorities for 2010 Summits

Significant Challenges Lie Ahead

By Wendy Dobson, University of Toronto

March 17, 2010

A year ago the world economy teetered on the brink of depression. Much has been accomplished since then. The prospect of looming catastrophe focused leaders' minds bringing about unprecedented cooperation among governments of the world's largest economies. Large fiscal and monetary stimulus packages greatly improved the growth outlook for 2010. But big challenges still lie ahead. Clearer evidence is needed of the resumption of organic self-sustaining growth in the largest economies. And coordinated policy actions are required to change the composition of global growth.

Every crisis opens windows of opportunities for reforms and this one was no exception. The G20 systemically significant economies elevated cooperation to the highest political levels. Leaders maintained a political leadership focus, charging the existing global economic institutions with implementation and reforming them where necessary. Now that their focus is shifting to sustaining growth and changing its composition a wider range of domestic policies will come under the microscope. The Mutual Assessment (MA) process, with technical support from the international institutions, will examine the global consequences of countries' domestic policies and identify opportunities for government to do things differently or do different things to contribute to a positive global outcome. The process could be seen to infringe national sovereignty – a very sensitive issue in some of the largest countries. Thus, as the Chairs of the process Canada and the Republic of Korea will face big challenges to ensure national interests and the global public interest are reconciled.

To put this concern in context, it is useful to recall a basic principle of policy cooperation: prescribed policy changes should be ones that are in the country's best interest as well as the global interest. And there are precedents: I think particularly of trade policy where, although the record is somewhat untarnished, governments have applied the lessons of 1930s beggar-thy-neighbor policies and protectionism has been quite muted to date. Unfortunately this good performance is offset by the failure of will to complete the Doha Round and at Copenhagen. Governments were unable or unwilling to reconcile the global interest with those of narrower special interests.

Progress under the Framework for Strong, Sustainable and Balanced Growth

There is no reason to relax as we look ahead to 2010 and 2011. Growth is being restored but on a multi-speed basis with China and India leading the world predicting 7-9 percent growth rates, while the US rebound is more modest and Japan and Europe are lagging with more sluggish growth and continuing uncertainty in Europe about the solvency problems of some of the southern members.

In each country governments and central banks are turning their minds towards macroeconomic exit strategies. Before implementing these strategies they are looking for evidence that the private sector business cycle is beginning to turn as businesses restock inventories, stop firing and begin hiring; that labor market expansion is supporting household income growth and consumer spending which in turn will encourage businesses to resume investing. To reach that stage, financial institutions must be willing to resume lending. If stimulus is withdrawn before organic private sector growth has gained this momentum these economies could enter a renewed slump. Exit too late, however, and precious resources are wasted and the seeds of future inflation sown.

We still lack clear evidence of rising final demand in the advanced economies and so the authorities are likely to err on the side of caution. A related concern is that many of the large countries have little room left for further fiscal stimulus because of high levels of indebtedness: the OECD estimates, for example, that debt in the advanced economies will be well over 100 percent of GDP in 2014. In countries with large credit bubbles interest rates are at historic lows and central bank balance sheets are in uncharted territory. With little room to maneuver in the face of still-high unemployment, we cannot be complacent about the threat of protectionist policies or political pressures to turn back globalization.

A troublesome aspect of the recovery is the uncertainty around financial sector reforms, in part because of pushback from powerful vested interests. Support for the financial sector needs to be unwound; banks' bad assets tackled and banks restructured if necessary; incentives are needed to make support less attractive; risks of future instability must be reduced and ways found to tackle future financial crises without taxpayer support. Acquired assets also need to be sold, recovering as much as possible for the taxpayer.

Exit must be well-timed but that is no reason not to be preparing medium-term strategies of fiscal consolidation and monetary exit. Both need to be signaled well in advance to condition expectations. It also needs to be stated that monetary policy should not be enlisted to reduce the real burden of public indebtedness.

More coherence and coordination among countries are needed in fiscal and monetary exit. China and India are already well advanced with their own articulated strategies while the EU Stability and Growth Pact's rules are forcing fiscal consolidation on a European schedule. The United States does not yet have a medium-term framework that restores public debt to sustainable levels, a topic to which I return.

Most advanced economies should aim to remove fiscal stimulus AND substantially improve primary balances in anticipation of long-term demographic shifts (which implies both tax reforms and changes to entitlement spending) while in China more social spending is needed.

A related principle is that governments should not just tighten fiscal policy but shift public spending in the direction of investments that foster future growth, such as education, green infrastructure, physical infrastructure upgrading and reducing distortionary taxes. This link between exit and rebalancing is crucial.

The central challenge in 2010: addressing unsustainable global imbalances

Front and center in the G20 are goals to restore global demand – and change its composition by rebalancing countries' reliance on external and domestic demand. The IMF's January 2010 numbers on world trade volumes show exports and imports bouncing back to 6 percent rates in 2010 and rising to 8 percent rates in emerging market economies in 2011. This could mean that too many governments are relying too heavily on exports to restore growth momentum.

The underlying issue therefore is to encourage reliance on domestic demand in current account surplus countries – and on more currency flexibility – and more reliance on exports in current account deficit countries.

Rebalancing will be both a technical challenge and the G20's biggest political challenge. Take the United States. Whatever are the US decisions on exit (and there are voices calling for more stimulus) the US lacks a medium-term fiscal consolidation plan. It is apparent from the Administration's optimistic 2011 Budget assumptions that the deficit-to-GDP ratio will near 11 percent in 2010 (down from 13 percent in 2009) and decline to not more than 4 percent between 2015 and 2020 (whereas 2-3 percent is considered to be sustainable). Private sector assumptions show the deficit remaining above 5 percent of GDP in the next decade. These numbers are not sustainable. The gross debt/GDP in 2014 will be 108 percent of GDP by IMF projections while the Administration estimates net federal debt in public hands will be 71 percent of GDP in 2012 and rise to close to 80 percent by 2020.

The measures proposed by the Administration in the 2011 budget amount mostly to expenditure compression. One has to conclude that Americans are asking for more government services and transfers than they are willing to pay for. Despite the simmering populist anger about “big government”, a sustainable fiscal position in the long term requires revenue raising and ideally tax reform, to shift the burden of taxes away from income and property towards consumption. Since no politician will be willing in the current polarized atmosphere to advocate revenue raising measures, the bipartisan congressional commission, with all expenditure and revenue items on the table, is a logical means to break through these attitudes of denial. Or a bond market revolt will force change.

China, the main actor on the other side of external imbalances, faces a structural policy challenge. In the short term the central question is whether China’s economic structure will be any different when the stimulus is withdrawn, with more consumption and less investment driving GDP growth? For the longer term the Chinese leadership is clear about relying more on domestic demand but related changes in institutions and incentives will take time to bring it about. To change the incentives for household saving, public spending on education, health care and pensions was increased three-fold between 2002 and 2008. A number of other changes are also under discussion or in train.

Yet many outsiders focus on exchange rate appreciation as China’s “silver bullet.” Allow exchange rate appreciation and China’s economy will rebalance. This assertion is conceptually correct since a flexible exchange rate in a surplus country should appreciate. But China manages its exchange rate, as do some other East Asian countries. So of all the changes China recognizes it must make, perhaps exchange appreciation is the most politically difficult because of powerful entrenched interests and uncertainties about the size and distribution of job losses as expenditure switching occurs. Sounds familiar? Yes, that sounds very much like the US dilemma.

What we should be encouraging, and what is in China’s interest as well, is a package of domestic reforms that will rebalance external and internal demand and shift growth to be less capital-intensive and less polluting and raise household incomes. These shifts are possible. Household incomes can be raised through by creating more labor-intensive jobs in the services sector and by raising productivity in industry with more knowledge-based production. This means deregulating services and raising productivity by raising educational attainment in the work force. One of my colleagues who has an ongoing survey of hundreds of nonstate Chinese firms observes how many of them are looking for workers with more than the compulsory nine years of basic education. Household savers should also earn more from their savings, which means interest rates should be deregulated – but first China needs a deposit insurance system. The shift away from capital-intensive production by the nonstate sector and China’s gigantic state owned enterprises can be accomplished in several ways: by requiring them to pay larger dividends to their government owners, and by raising energy, land, environmental and capital costs – each of which is either subsidized either directly or indirectly by lax enforcement of existing regulations. And it requires exchange rate appreciation. But what seems most likely is that we will see *real* rather than nominal appreciation through higher domestic inflation.

A number of these measures are also desirable in other East Asian countries which depend on export-led growth. To reduce export reliance resources will have to be shifted to nontradables like services and infrastructure. Thus, developing a package of common measures that are desirable changes in themselves but also contribute to global rebalancing makes the most sense for the G20.

Such rebalancing is manageable as demonstrated by a recent study carried out by a trans-Pacific team in which I participated. [1]

We looked at pre-crisis expenditure patterns in 2007 and estimated what expenditure changes would be required to reduce the US current account deficit to 3% of GDP (see Table below). It would have to decline by $304 billion. We then allocated this amount across those economies with CA surpluses, in proportion to the share of each in total surpluses. The implication is that China would absorb a third of the reduction, reducing its CA surplus by $102 billion (this arbitrary calculation could but does not include Japan and Middle East in the absorption).

Next, we allocated the reduction across expenditure categories within countries, assuming that they will fall on consumption in the US and China (because consumption is too high and too low, respectively, and needs to change) and on investment in SEAsia (where investment is considered to be too low). Thus 60% of the adjustment is allocated to US and Chinese consumption, respectively; another 20% is allocated to SEAsian investment, with the residual 20% allocated to other expenditure categories.

The resulting expenditure changes (in the first Figure below) are quite interesting. In China the recalculation brings consumption 5% above actual 2007 levels. We think this is a credible estimate since it is about what would happen during 8 months of growth, or if Chinese consumption growth were to exceed GDP growth by 1.67% a year for 3 years. The demand effects in the United States would be smaller: around 2% reductions in consumption, investment and government spending. In SE Asia and South America similar percentage changes would occur in investment and government expenditures.

[1] This study is *Inclusive, balanced, sustained growth in the Asia-Pacific*, 2010, Petri, Peter, Ed. (forthcoming from the Institute of Southeast Asian Studies (ISEAS) in Singapore).

We also calculated trade adjustments which were allocated 50:50 between exports and imports (see the second Figure below). Such a change would lead to a 5% change in US trade (with exports rising more than imports fall) and around 2-4% changes in trade in other regions.

This static exercise suggests that rebalancing is manageable. $300 b is a large absolute number, but relative to the $28.8 trillion Asia-Pacific economy, it is not. Indeed, such adjustment would be less damaging than market-driven changes in recent years -- even if politically difficult.

G20 Mutual Assessment and Rebalancing

Politics is where the G20 comes in. The G20 will have to find ways to encourage this rebalancing and it should be linked to countries' exit strategies. The IMF scenarios exercise planned for the lead-up to the Toronto meeting will be based on countries' own forecasts and adjustment packages. Its value lies in high lighting both the possibilities, as we have just seen, and the global consequences of inconsistencies among these policies. The other focus of the exercise should be to link exit strategies to rebalancing by shifting public spending in the direction of investments that foster future growth.

Rebalancing is manageable but that does not mean it will happen. International and domestic political considerations are quite likely to intervene and so we must consider alternative tactical approaches to ensure forward momentum. The first alternative and the most desirable would be for the largest countries to provide leadership by example. If the United States had a credible medium-term fiscal consolidation strategy it would be the natural leader of the Mutual Assessment process. But how likely is this to happen at this stage of the US electoral cycle? It could happen in the wake of a renewed crisis triggered by a bond market revolt.

A second alternative is for key trading partners or neighbors to use quiet diplomacy with both the United States and China. Pressure on China would most usefully come from other developing countries, particularly those facing rising competitive pressures from China in their export markets.

The third alternative is for a group of like-minded countries, possibly led by Canada and South Korea, to lead by example. The most credible members of the group would be other East Asian current account surplus countries which come up with their own strategies to reduce dependence on exports and which pressure each other by example. South Korea's President, Lee Myung-bak, has foreseen such a role and has expressed his government's determination to provide an example. Fiscal stimulus is front loaded and is focused on human capital investments in health care and social welfare spending and on technology and productivity, particularly a "Green Korea" strategy of investing in energy conservation, clean energy R&D and energy efficient vehicles and transportation systems. Other East Asians are looking at measures to reduce export incentives, increase competition, deregulate services and encourage green and other needed infrastructure projects.

Conclusion

The challenges of putting the G20's Mutual Assessment process on a credible track are large and and imply significant risks. One risk is that governments in key countries are unable to muster the necessary political will to adopt the medium-term strategies required for rebalancing. It is not enough simply to craft exist strategies that restore organic growth. Indeed there are risks of renewed financial market volatility in the absence of medium-term plans.

The other risk is that leaders opt for quick fixes and so declare success at the June and November summits. The United States and China are at the center of these issues. Each faces adjustments that are unquestionably in its own long term interests but which are politically difficult to execute because of the increasingly sensitive stages of the US electoral cycle and China's 2012 leadership succession. Policy and institutional changes in China are also politically connected with US policy change in an "after-you-Alphonse" fashion. In both cases outside pressure will have little impact and could even be counter-productive if publicly applied. Consequently, it will be tempting for each to tolerate higher inflation which effectively would erode China's exchange rate undervaluation and the real value of US indebtedness. But at what long term cost?

This is why I conclude that Canada will have the easy part in June when G20 members identify desirable policy changes. It is around the November meeting in South Korea that the G20 faces its most formidable challenge of demonstrating forward momentum in actual policy changes. The fact that the meeting takes place in South Korea may turn out to be extraordinarily fortuitous if President Lee is able, by example, to encourage change.

Beyond that, I conclude that we need to step back and ask ourselves if the necessary leadership and vision exists to support continued multilateralism. Do we have the leaders in countries and international institutions with the necessary ambition, credibility and power to persuade others to take the tough decisions that will get the shifting world economy back on track? We cannot afford more deadlock and inertia of Doha and Copenhagen or the G20 will lose its credibility and effectiveness as a more inclusive world economic forum. And the burdens of this global financial crisis on future generations will only grow.

Table: Pre-crisis Imbalances were not sustainable, (USD billions, 2007)

		Expenditures						Current
	GDP	Cons	Inv	Gov	Exp	Imp	Net Exp	Acct
World	**54,841**	**31,835**	**12,810**	**9,810**	**17,149**	**16,763**	**386**	**299**
European Union(EU15)	15,724	8,998	3,359	3,227	6,147	6,006	141	9
Middle East	1,394	589	347	203	811	556	255	265
Rest of the World	8,895	4,742	2,575	1,462	3,076	2,959	117	63
Asia-Pacific	**28,827**	**17,506**	**6,529**	**4,919**	**7,115**	**7,242**	**-127**	**-38**
China	**3,652**	**1,340**	**1,493**	**488**	**1,773**	**1,443**	**330**	**397**
China (exc. Hong Kong)	3,445	1,216	1,450	472	1,342	1,035	308	372
Hong Kong	207	125	43	17	431	408	22	26
Advanced Asia	**7,028**	**3,915**	**1,772**	**1,188**	**2,100**	**1,947**	**153**	**221**
Australia	910	508	257	161	183	199	-17	-57
Japan	4,384	2,469	1,057	786	772	699	73	211
Korea	1,049	571	309	154	440	424	16	6
New Zealand	131	76	32	25	38	39	-1	-11
Singapore	168	64	35	16	384	332	53	39
Chinese Taipei	385	227	83	47	283	254	29	33
Southeast Asia	**1,089**	**640**	**268**	**111**	**637**	**567**	**70**	**60**
Brunei Darussalam	12	2	2	3	8	3	5	6
Indonesia	436	275	108	36	127	110	17	10
Malaysia	187	85	41	23	206	168	38	29
Philippines	137	100	22	14	62	61	1	7
Thailand	247	132	66	31	180	161	19	14
Vietnam	70	46	30	4	55	64	-10	-7
North America	**16,533**	**11,294**	**2,880**	**3,060**	**2,446**	**3,147**	**-701**	**-720**
Canada	1,432	799	326	279	500	471	29	15
Mexico	1,023	669	266	105	290	306	-17	-8
United States	14,078	9,826	2,289	2,676	1,656	2,370	-714	-727
South America	**525**	**316**	**117**	**71**	**160**	**138**	**21**	**4**
Chile	164	89	34	18	77	55	23	7
Colombia	208	132	51	34	35	44	-9	-6
Ecuador	46	29	11	5	16	16	0	2
Peru	107	66	21	13	31	24	7	1

Source: CEIC Oct 2009.

This table and other graphics are found in “Inclusive, Balanced , Sustained Growth in the Asia-Pacific”, 2009. Yongfu Cao, Wendy Dobson, Yiping Huang, Peter Petri, Michael Plummer, Raimundo Soto and Shinji Takagi, Singapore: Pacific Economic Cooperation Council.

Figure: Changes in Expenditure Patterns

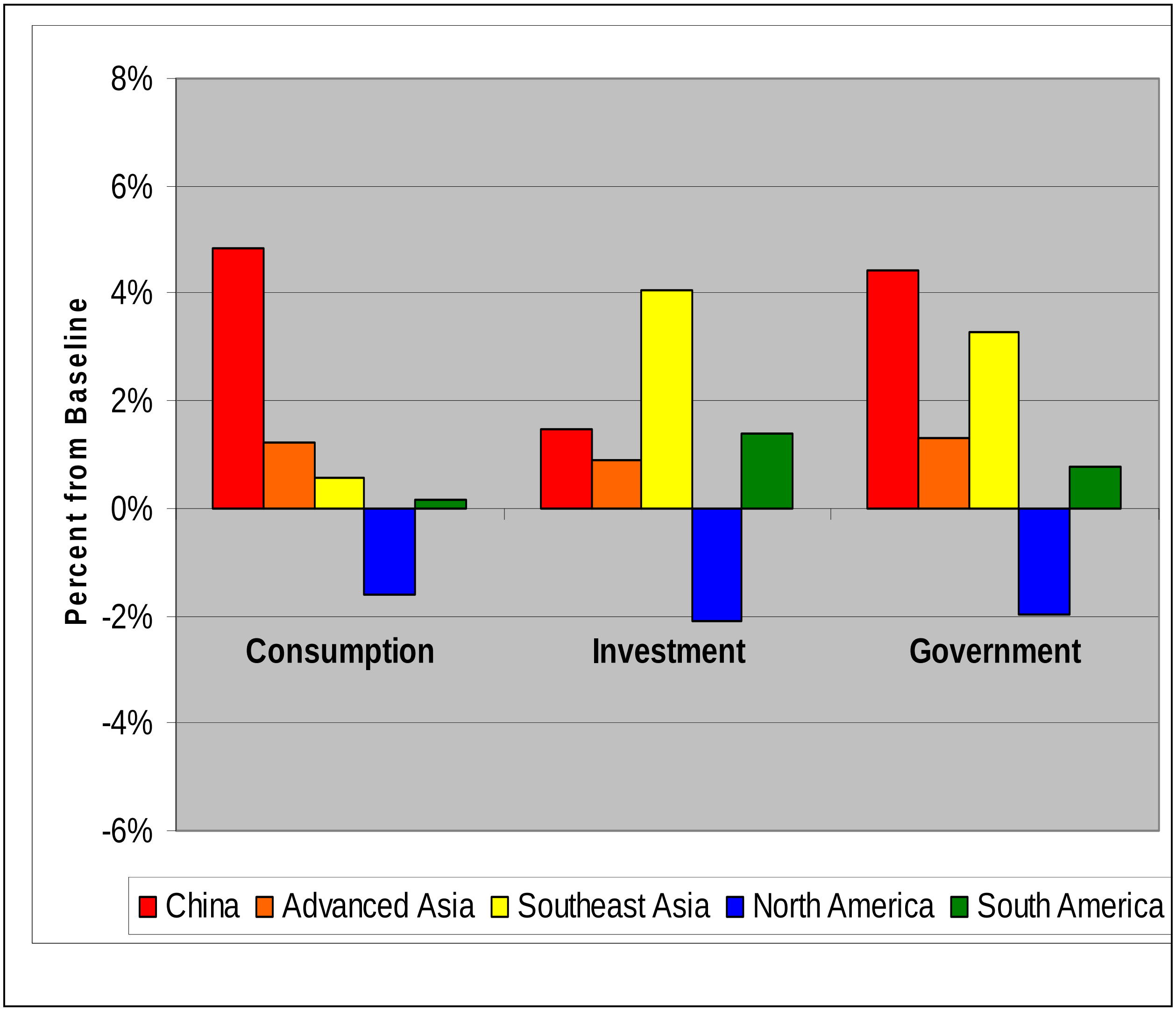

Figure: Changes in the Pattern of Trade, by region