OPINION

New measures critical to keeping growth momentum from faltering

Financial system reforms needed in India and China to support economic expansion

Eswar Prasad and Karim Foda

Times will be over when policymakers can expect more growth without bold policies to raise their economies' resilience. © Reuters

The world economy's growth momentum remains strong but is leveling off as the winds of trade war and other geopolitical risks, domestic political fractures and debt-related dangers loom, with financial markets already reflecting mounting vulnerabilities.

Emerging markets contributed to the broad-based and synchronized global upturn last year and many are on track to turn in an even better growth performance in 2018, as confirmed by the latest update of the Brookings-FT Tracking Indexes for the Global Economic Recovery.

Emerging Asian economies have benefited from strong growth in both domestic demand and exports. However, many emerging markets remain vulnerable to capital flow reversals, particularly the possibility of the eurozone and Japan this year joining the U.S. in tightening their monetary policy stances, as well as disruptions to international trade flows.

China's growth remains robust and well-balanced across sectors and categories of domestic demand. President Xi Jinping has locked in his political power, put in place a team of experienced and reform-minded officials to guide economic policy, and hinted at major economic and financial reforms.

The key challenge for China will be the execution of proposed reforms not just to the financial system, but also to other parts of the economy, especially state-owned enterprises. The direct effects of an all-out trade war with the U.S. would at worst be a temporary and modest knock on Chinese and global growth, but there could be longer-term repercussions on the global trading system.

India remains the world's fastest-growing major economy. Resurgent manufacturing, investment and labor productivity have improved the composition of growth. India is reasonably well-insulated from global trade and financial shocks, although its financial system remains a weak link that will continue to restrain growth.

South Korea's growth picked up last year, as political uncertainties abated, helping to boost investment and consumption. Expansionary fiscal and monetary policies have also supported growth. Gross domestic product growth may slow moderately this year however as rises in investment diminish.

Strong investment, consumption and export growth have led to robust GDP gains in Indonesia. Solid job growth and low inflation have boosted private consumption, and the pickup in global demand is likely to help maintain rapid export expansion.

Among advanced economies, the pace of growth has moderated slightly in 2018. Investment and productivity growth improved last year, but gains in employment and wages remain modest in many of these economies. After a good start at the beginning of the year, equity and bond markets in the advanced economies took a sharp hit but appear to have stabilized.

The Japanese economy, which is in the midst of a long and mostly steady expansion, continues to perform well but is facing a slowdown in domestic demand growth as wage growth eases and trade frictions rise.

The U.S. economy remains in robust shape, with growth in GDP, industrial production and investment holding up well. In tandem with strong consumer confidence and employment growth, wage and inflationary pressures have picked up slightly, although less than would be typical at this stage of the cycle.

The U.S. is engaged in a perilous macroeconomic experiment, with the injection of a significant fiscal stimulus even as the economy appears to be operating at or above its potential. The Federal Reserve is likely to lean hard against potential inflationary pressures as this stimulus plays out.

Export growth has been buoyed by a weak dollar and strong external demand, but the U.S. trade deficit has still risen over the past year. The large bilateral trade deficit with China remains a flashpoint, setting in motion trade tensions that could have implications for China, the U.S., and the entire world economy.

In 2017, the eurozone turned in its fastest pace of growth in the last decade. Growth in overall GDP as well as in manufacturing and services remains solid but has cooled off slightly this year. Centrifugal political forces in many countries, rising global trade frictions and the withdrawal of monetary stimulus could lay bare some of the unresolved structural problems and tensions in the zone.

The U.K. continues to lag other European economies in terms of GDP growth. A weak pound and strong demand from trading partners have resulted in a good growth contribution from net exports. Uncertainties fueled by messy Brexit negotiations are likely to remain a drag on investment and GDP growth.

Brazil and Russia have recovered from their recent recessions, but both economies continue to record only modest growth and remain vulnerable to domestic and external shocks. In Brazil, despite domestic political turmoil, employment growth has held up well, and so have consumer and business confidence. Both economies have experienced good export gains.

The era of growth fueled by macroeconomic stimulus, with no apparent adverse side effects such as high inflation, appears to be drawing to an end. In the absence of deep-rooted reforms to improve productivity, it will be difficult to ratchet up or even sustain high growth in the major economies.

Mounting public debt in the U.S. and other advanced economies, compounded by unfavorable demographics, and rising external debt levels of some emerging market economies are risk factors that also reduce policy space for responding to shocks. Any of the multitude of risks on the horizon could derail growth if policymakers count on momentum continuing without additional measures to increase their economies' resilience.

Eswar Prasad is a professor in the SC Johnson College of Business at Cornell University and a senior fellow at the Brookings Institution. Karim Foda is an associate fellow at Brookings.