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A pattern emerges

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When they met in Washington last November they were still in a state of shock at the wreckage that was the private banking system. Meeting again five months later in London they were faced with an ever deepening global recession and the real risk of global contagion.

This week, when the leaders of the Group of 20 leading economies gather in Pittsburgh for their third meeting within a year, the world economy is once again growing, equity markets have recovered most of their losses and talk of a coming depression has disappeared. Participants would be excused for feeling they have been through the mill.

Sentiment and economic numbers have improved but policymakers are far from euphoric, chastened by the experience of the past year and the desire to prevent any repetition. They also know that a surprisingly sunny economic spring does not guarantee a sizzling summer, let alone an agreeable climate in future years to come.

The contrast with April’s London summit is stark. Then, leaders contented themselves with grand gestures, devising ways to claim unimaginably large quantities of money were being thrown at the crisis. Now the focus for the body that has in effect become the most important international economic decision-making forum, is of how to clear up the mess, and of the gritty process of prevention. Then, solidarity reigned; divisions were dangerous. Now, countries are once more forging their own paths. Uniform action will be harder and, in some areas, less necessary.

The main reason for this change is the resumption of growth. The French, German and Japanese economies began to expand in the second quarter. A surge of bank lending and infrastructure spending pushed China’s annual growth rate to 7.9 per cent. Last week Ben Bernanke, Federal Reserve chairman, said the US recession was “very likely over”; Mervyn King, his UK counterpart, declared: “There are now signs that growth has resumed in the third quarter.” Such positive signs have allowed Dominique Strauss-Kahn, head of the International Monetary Fund, to conclude: “The global economy appears to be emerging at last from the worst economic downturn in our lifetimes.”

This represents huge progress in less than six months. The collapse in confidence has been stemmed. A sense of normality is replacing panic. But even though the world economy is emerging from its first contraction since the Great Depression of the 1930s, policymakers cannot relax.

To start with, renewed growth has not yet trickled down to the poorest, the countries and people who had nothing to do with the cause of the crisis yet suffered its consequences as deeply as anywhere else. The IMF expects low-income countries to perform worse in 2009 than it expected in March, as trade, remittances, foreign investment and aid have all fallen short of expectations. The World Bank estimates the crisis has pushed another 90m people into “extreme poverty”, living on less than $1.25 a day. Claire Melamed, head of policy at ActionAid, a charity, says: “Any talk of recovery in Africa is almost certainly premature. The squeeze on government budgets that we are facing here is also being felt in Africa."

Even in large advanced economies, the challenges are hardly any easier. Though the recession has ended, few forecasters yet think growth will be sufficiently fast in the quarters ahead to reduce unemployment. Global growth so far has also been dependent on fiscal stimulus and companies replenishing depleted stocks of goods, rather than on buoyant private consumption or investment. Neither can continue indefinitely, however – the emergency fiscal boosts are time-limited and inventory adjustment too will naturally end.

Some of the fiscal pump-priming is already over. The "cash for clunkers" car scrappage schemes in the US and Germany have expired; the UK is preparing to tighten fiscal policy by 1 per cent of national income at the turn of the year. Both threaten to put brakes on recovery by withdrawing temporary spending from the economy.

But it is longer-term barriers to a healthy recovery that most concern policymakers. Government budgets have borne the brunt of the economic crisis as tax revenues have fallen alarmingly and public spending has been raised to limit the damage wrought by the recession.

The pre-crisis average G20 government deficit of 1.1 per cent of national income is expected to surge to 6.9 per cent in 2010. The IMF expects advanced G20 country gross debt to shoot up from just below 80 per cent in 2007 to 110 per cent in 2010, raising fears that global savings will be used to keep governments solvent rather than to fund productive new investment. At the very least, governments' additional funding requirements threaten to raise long-term interest rates. Even with official rates at all-time lows, credit conditions are still tightening.

Taken together, these factors leave economists in little doubt that much of the output and employment lost is not just sitting temporarily idle, waiting to come back on stream when demand and confidence recovers. It will be lost for good. The skills of the unemployed will deteriorate, some otherwise viable companies have collapsed, and capital – plant, machinery and buildings – will be scrapped.

William White, former chief economist of the Bank for International Settlements, argued last week that mismatches between patterns of global supply and demand will add to the painful adjustment. "Many countries that relied heavily on exports as a growth strategy are now geared up to provide goods and services to heavily indebted countries that no longer have the will or the means to buy them." The world has capacity to make and distribute goods no one can afford, and that no one even wants.

The IMF agrees. It will present evidence next month, drawn from 88 banking crises around the world over 40 years, suggesting that growth tends to return to a normal rate but that the output lost in a recession is gone for good.

. . .

The difficulty knowing how much output is lost for good presents a horrible challenge to policymakers. How should they order the removal of extraordinary financial intervention, unprecedentedly loose monetary policy and fiscal stimulus? And when should they start?

G20 finance ministers agreed this month to keep the expansionary policies "until recovery is secured" – but failed to explain what would constitute a durable recovery.

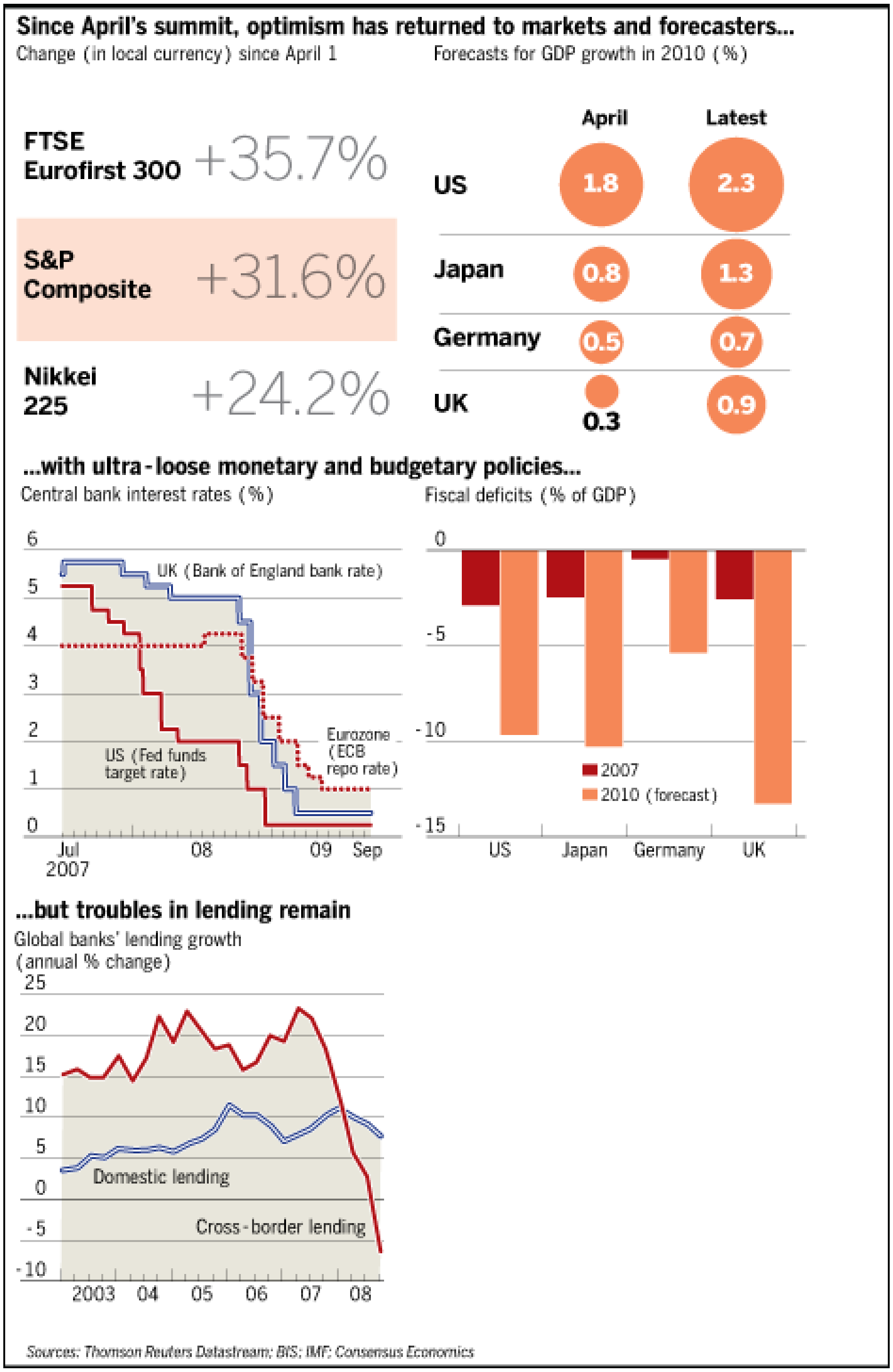
Individually they know that by moving too early they risk plunging their economies back into recession. But if they leave policy loose too long, the risks of different calamities mount. Banks could become dependent on the numerous state guarantees they now enjoy, taking unreasonable risks again. Battered public finances could unsettle bond markets to the point that they consider lending to governments a decidedly risky business and charge much more for the pleasure. Inflation might once again rear its head if households lose confidence in the authorities' efforts to manage money.

Collectively they realise the world economy could, all too easily, slip back into the patterns of huge trade imbalances – US and UK consumption and borrowing matched by production and saving in Japan, Germany, China and oil producers such as Saudi Arabia and Russia. Unlike in the past decade, however, it would be the public sector doing the borrowing in the US and UK instead of households borrowing to finance consumption.

Just as the pattern of global trade imbalances was proved unsustainable when new lending to the US private sector in the form of subprime mortgages turned sour, ever increasing public deficits cannot sustain a durable recovery.

Olivier Blanchard, IMF chief economist, says enduring recovery requires a shift in the pattern of global demand away from the US: "If the US recovery is to take place, if the fiscal stimulus must be phased out, and if private domestic demand is weak, then US net exports must increase."

There are signs that this pattern of growth is emerging around the world. China's trade surplus has fallen sharply on the back of a surge of imports. Jim O'Neill, chief economist of Goldman Sachs believes that China "will flirt with a trade deficit in 2010".



But his view is far from the consensus. Most economists think the world risks slipping back to its imbalanced ways. Smaller emerging nations have learnt that economies that survived the crisis best had huge foreign exchange reserves and were not forced to suffer the stigma of borrowing from the IMF. Germany and Japan remain dependent on export for their recovery. China's second-quarter growth was dominated by investment but this will merely add to its capacity to export, says Eswar Prasad of Cornell University. "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," he says.

Within the G20, Europe and the US share the consensus view and hope to use this week's summit to agree a plan for more balanced world growth and a process to ensure countries with trade surpluses face international pressure to boost domestic spending and demand.

They argue that this is only fair as deficit countries always face the threat that they might run short of willing financiers, but countries running trade surpluses face no similar threats.

China, the world's biggest financier, disagrees strongly with this goal. It wants the G20 to focus on avoiding protectionism – a dig at the

US decision last week to impose higher duties on Chinese tyres.

The hope must be that, whatever the G20 achieves, the world economy first secures its recovery and then achieves more balance – whether naturally through the self-interest of individuals and countries or through the imposition of tougher global rules to avoid persistent surpluses.

But such a road to stability will include many obstacles. The G20 leaders may cheer the end of recession, but they know that the hard work in creating a sustainable global recovery is only just beginning.

Obama’s exemplar: from depressed steel town to diversified economy

As host of the Group of 20 leading nations summit, the city of Pittsburgh in western Pennsylvania will impress thousands of visiting diplomats, economists and journalists this week with its remarkable story, writes Justin Baer.

The tale of its quiet transformation from depressed steel town to US President Barack Obama’s exemplar for urban renewal in fewer than 30 years is worth a listen, if only to warn of the dangers of depending on any single engine of economic growth. There are lessons here for those US towns such as Detroit still clinging to their past as a hub for the nation’s troubled carmakers.

By the 1980s most steel mills were gone for good, leaving residents with little choice but to embrace a more diversified economy. Although the city has not recovered from the loss of a generation of workers who left following the industry’s demise, there is a sense of optimism. Today, Pittsburgh is home to more than 100 multibillion-dollar companies, including bellwethers such as HJ Heinz, the food group; Alcoa, the aluminium maker; US Steel; and PNC Financial Services Group.

The needs of an ageing population have helped fuel the growth of medical research. This, along with the presence of research schools such as Carnegie Mellon University, has helped develop and nurture start-ups in fields ranging from software and biotechnology to renewable energy. Large endowments and foundations have helped sustain the cultural and educational institutions that bear their names, and have also helped support the entrepreneurs of the future.

But lost in the justifiable praise for the city’s progress is the fact its population, much like those of its neighbours from San Francisco to New York, is still working its way through a brutal economic downturn. The city’s jobless rate inched above its highest in 17 years this summer, with few industries emerging unscathed from what many believe was the worst of the recession. In June the rate stood at 7.7 per cent. “Clearly as an economy it has diversified, but there has been no escaping the national recession,” says Christopher Briem, economist at the University of Pittsburgh’s Center for Social and Urban Research.

Though the city’s jobless rate has climbed in the past year, it remains below the national average, just as in the previous two recessions. Back in 1983, when Pittsburgh was dependent on manufacturing, the unemployment rate peaked at 17 per cent, well above the 10.8 per cent peak the US reached during that downturn. “Manufacturing had always exacerbated the national recession here,” Mr Briem says. “If we were still the steel region we were, things would be far worse.”