G8 Summit - Hokkaido

Leaders should debate new growth model

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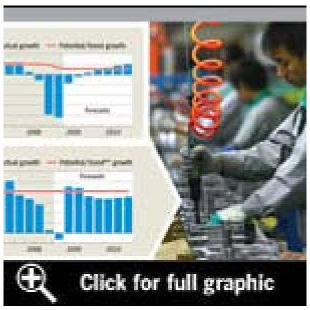
As far as weak statements go, "the world economy appears to be past the worst" is pretty feeble. But at an extremely uncertain time, it sums up the consensus on the outlook for the global economy.

Financial markets have improved considerably since their trough in March. The big equity markets around the world have rallied by 25-35 per cent over the past quarter. Companies have been able to issue new equity and bonds. In the US, corporate bond issuance this year has exceeded the first half of 2007. In Europe, sub-investment-grade corporate bonds have been issued for the first time since 2007.



Business sentiment indicators have followed financial markets higher. The recovery in global business confidence is such, says Julian Callow of Barclays Capital, that it "has led to growing concerns in the bond market that there could be too much stimulus, ultimately resulting in inflation".

In its latest Economic Outlook, the Organisation for Economic Co-operation and Development says this combination of green shoots alongside extremely loose monetary and fiscal policy will help to support growth later this year and expansion that will gather pace in 2010.

Signalling the first upward revision to its forecast for two years, the OECD said "the risk of catastrophic events has become more remote". Deflation and a return to the 1930s can, for now, be discounted, it implied.

But having suffered the worst recession since the second world war, there is little room for optimism among most economists. What started in 2007 as a severe liquidity crisis linked to US sub-prime mortgages and a stubborn global commodity inflation problem that weakened household and corporate finances still invokes fear because of its sudden transformation into a global crisis last autumn.

The loss of confidence and trust resulting from the collapse of Lehman Brothers caused a sudden plunge in business investment and orders of machinery and consumer durables. A slump in industrial production and world trade was the result, as companies struggled to reduce stocks, sending economies across the world plunging.

In the final quarter of 2008 and the first quarter of 2009, advanced economies contracted at an annualised rate of about 8 per cent and emerging markets also experienced falling output. Rarely has the world economy felt more integrated, with surplus and deficit, rich and poor, industrial and service-orientated economies shrinking in unison.

Luckily that plunge appears now to be over. Economic statistics no longer look like a wobbly path followed by a vertical line down. There is even talk among central bankers of exit strategies from the extraordinarily low interest rates, unorthodox policies and lax budgeting.

The most important precondition of recovery is to ensure a resumption in global demand growth. Loose monetary policy across the world will aid consumption and investment. Fiscal policies in advanced economies are so loose that they will also boost household and government consumption. Such has been the loss of output that inflation is likely to be tamed for some time to come.

This would imply a return to pre-crisis patterns of world growth. Debt-led consumption in advanced economies, with export-led production in the emerging world.

In the short term, few would worry about the source of growth, which appears most likely to come from large emerging markets, such as China and India. But the most likely outcome is for a modest global recovery to arrive with huge global trade imbalances more or less intact.

China, Germany, Japan and oil producers will have trade surpluses and export of capital to match the deficits in the US and a few other economies.

Although these global imbalances helped cause the crisis, says Eswar Prasad, professor of trade policy at Cornell University, they are also probably the best hope of a speedy return to growth in the global economy, given the industrial structure of the main economic powers.

But instead of being fuelled by US private-sector borrowing for consumption, the borrowing is now being undertaken by the public sector in most advanced economies.

So the global economy is at a turning point. Green shoots are emerging, as confidence and trust slowly return to markets and economies. But as the Group of Eight meets in Italy, the big question remains: how to ensure unbalanced growth does not lead to another crisis.

The G8 is not the ideal body for this discussion, as China is missing. But, as still so often in the global economy, it can start a wider debate. Unbalanced growth must certainly be time-limited. The public finances of the G8 economies demand that government-deficit-led expansion is strictly temporary.

The challenge for world leaders is to debate how they should follow the Bank for International Settlements' advice in its annual report that a true economic recovery "means moving away from leverage-led growth in industrial economies and export-led growth in emerging market economies".