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Alternative scenarios for the post-crisis global economy

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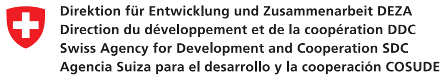

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Alternative scenarios for the post-crisis global economy

Marta Castello Branco*

1. Global trends

We are moving toward a multi-polar world. The last two decades have witnessed a shift in the post-war world economic and political order, with a gradual decline in US power and the steady rise of China, India, and other emerging countries.

The American retreat has created a vacuum in global leadership. The growing economic importance of emerging countries became evident in the aftermath of the 'Great Recession' of 2008, as their strong economic performance helped stabilize global output. Going forward, it is unclear, however, whether they have the potential to replace the advanced Western economies as the new engines of growth and as the new leaders in technological innovation. At the same time, the increasingly dysfunctional political system of the US has further undermined confidence in its capacity to lead.

Even the U.S. role as the global financial anchor may come into question. The historical downgrade of US sovereign debt in early August could be a prelude to a potential challenge to US dominance in the global financial system. If the current unsustainable economic policies are not properly recalibrated, the US dollar may eventually lose its global reserve currency status. For the moment, the greenback does not have to share the world stage, given the lack of alternative reserve currency options. But the perceived decline in the US global standing is likely to encourage some G-20 countries to press ahead with moving toward a multiple currency international financial system.

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Finally, economic anxiety is becoming the new normal in an increasingly interconnected and highly leveraged world economy. The transition to a multi-polar system is taking place amid growing uncertainty and stiffer global competition. The 2008 financial crisis put an end to an era of unprecedented prosperity in advanced countries, as the debt-financed boom of the preceding years gave way to asset bubbles and high budget deficits, dragging the world economy along. In the developed world, the price tag for the financial excesses of the past decades has come in the form of difficult policy dilemmas, as they face increasing political pressure to focus on fiscal austerity when their economies are stuck in a low-growth mode.

2. The party is over

The global economy recovered from the 2008 crisis—if at all—at different speeds. Tepid growth in developed countries has been offset by a strong rebound in emerging markets. Uneven recovery has also been the norm within the eurozone, with core economies performing strongly, while their peers in the periphery lag behind, dragged down by austerity policies aimed at regaining competitiveness and restoring public debt sustainability.

The flagging global recovery is threatened by governance failures in Western democracies. In the US and in several European countries, the private debt accumulated during the boom years is being transformed into public debt, setting the stage for debt crises and sluggish growth. Historical experience suggests that recovery from financial boom-bust cycles is likely to be slow and fragile, since it takes time for households, businesses, and governments to repair their balance sheets. Moreover, the global scale of the current cycle clogs the external growth escape route usually available to individual countries trying to recover from a financial bust. While the economic woes are clearly challenging, there is growing consensus that inadequate policy responses have fueled worldwide uncertainty, making things far worse.

By contrast, inflation control is now the key concern for many overheated emerging countries. They rebounded strongly from the 2008 crisis, on the back of large fiscal and monetary stimulus, and keep growing at a fast (albeit slowing) clip. But the resulting credit booms have raised inflationary pressures, limiting their ability to offset additional shocks from the developed world and support global demand. Loose monetary policies in advanced countries have created new challenges for booming emerging markets, as they contributed to inflate prices, fuel asset bubbles, and strengthen domestic currencies, stoking fears of "currency wars". Going forward, sustainable medium-term growth in emerging countries is contingent on the effective implementation of critical structural reforms.

Emerging market growth may be insufficient to offset the synchronized slowdown in the developed world. There is now mounting evidence that the world economy is stalling, raising fears of a double-dip recession. Several recent financial reports suggest that the recovery in global manufacturing is running out of steam, while downward revisions to US GDP data point to a worse recession and weaker recovery than previously contemplated, despite massive policy intervention. Clearly, by any economic measure (growth, consumer spending, housing and stock prices, investor/consumer confidence), the US economy is struggling. The recent slowdown in Germany raises fresh doubts about the eurozone recovery, while growth is also anemic in the UK and in Japan.

3. Global confidence crisis

A crucial factor undermining global growth prospects is generalized uncertainty. The gyrations in financial markets in (Northern Hemisphere) mid-summer reflect an erosion of market confidence, following a string of gloomy economic data in the US and renewed tensions in the eurozone only weeks after European leaders agreed on a revamped crisis resolution scheme.[1] The subsequent loss of triple-A credit status by the US, together with rising fears about the soundness of European banks, spooked investors further, sending stock markets nose-diving across the globe in early August.

This record financial volatility reflects a deep-seated confidence crisis on both sides of the Atlantic:

- In the US, policymakers had to address an artificially-created crisis to raise the country's statutory debt ceiling. The debt-ceiling deal reached after acrimonious debate between Republicans and Democrats averted default, but failed to put the public finances on a sustainable path. In fact, the deal managed to achieve the opposite of what was needed: the agreed medium-term fiscal adjustment is too modest, while the short-term cuts threaten to derail the fragile recovery. More importantly, the "sacred budget cows" of each party remain untouched, since the deal does not include tax increases or cuts in entitlement programs (pensions and healthcare for the elderly and poor). Entrenched ideological positions on both sides have so far prevented the adoption of the mainstream solution, which would combine credible medium-term fiscal consolidation (and reform) with short-term support for the recovery.
- By contrast, the eurozone is facing a very real sovereign debt crisis with systemic implications. The crisis has exposed governance flaws and the lack of solidarity among member states, unveiling the vulnerabilities of the "European Project". With core eurozone banks highly exposed to peripheral countries' sovereign debt, the risk of contagion increased significantly during the year, raising doubts about the effectiveness of the new crisis resolution mechanism, and increasing pressure on governments to authorize a larger expansion in the rescue fund. But with increasing risk of contagion to core economies such as Spain and Italy, it is unclear whether the enlarged bailout fund would have enough firepower to reassure financial markets.

In both cases, policymakers' actions do not match the size of their economic challenges. The lack of political will to tackle the fundamental economic problems in

[1] In mid-July the European Council approved a second bailout for Greece and granted the European Financial Stability Facility (EFSF) additional powers, allowing the EFSF to repurchase bonds in the secondary markets, extend short-term lines of credit to vulnerable countries, and provide cash to recapitalize eurozone banks. However, the EFSF would be operational only after ratification of the package by all seventeen eurozone countries.

a timely fashion has undermined confidence in the ability of policy leaders to provide coherent responses to the crises. There is also a perception that policymakers in the US and in the eurozone have exhausted their fiscal and monetary policy ammunition.

Bickering politicians are not being helped by sparring economists. The current political polarization in the US mirrors the lack of consensus among economists about the diagnostics and the appropriate policy response to the fiscal crisis. For some economists, the key problem is the unsustainable debt. The related solvency crisis requires deleveraging, which would be only slowed down, if not worsened, by Keynesian-type fiscal stimulus. The correct policy prescription would be to provide incentives to speed up the deleveraging process in the private sector, including mortgage write-offs. While acknowledging the debt overhang, other economists believe the main short-term problem is lack of demand, and the related jobs crisis calls for Keynesian stimulus to rekindle growth. In their view, the current drive for fiscal austerity in the US and in the eurozone periphery would adversely impact global growth in the short-term, making it harder to reduce the long-term debt burden.

Across the Atlantic, the eurozone is caught with incompatible growth models within an incomplete union. The fiscal austerity imposed by core countries on the periphery (after happily shipping their exports to them) has exacerbated the north/south divide. The key question at this point is whether/when the core countries will accept the logic of a monetary union and move toward greater fiscal integration. While it is clear that more fiscal policy coordination and distributive mechanisms are needed to preserve the single currency, currently there is little appetite for a fiscal transfer union or, more broadly, for putting EU interests ahead of domestic priorities.

4. Main challenges ahead

As a result of globalization, domestic growth strategies have become more vulnerable to external shocks. Financial sector spillovers are especially powerful, since they can be transmitted very quickly through increasingly interconnected financial markets. While the eurozone crisis is the immediate threat, the long-term risks implied by the dire fiscal situation in the US can severely impact the global economy.

- High public deficits and unsustainable debt burdens will shape the long-term growth prospects in the US and in the eurozone. The resolution of both debt crises will necessarily imply a transfer from creditors to debtors, through default, inflation, or financial repression; uncertainty about which one of these options will be chosen is causing financial markets jitters.
- For China, long-term growth prospects will hinge on policymakers’ ability to accomplish an orderly transition to a consumption-driven growth model. However, the changes in the incentive structure needed to reduce dependency on export-led growth and low wages may take a long time to materialize.

4.1. United States

The main challenge for the US is to stabilize its public debt at sustainable levels without compromising growth prospects. A tall order indeed, considering the growing fiscal burden associated with the unfunded pension and healthcare liabilities of an aging population, and the strong political pressure against raising taxes to meet these promises, or to break the promises.

The long-term outlook could be bleak. Without an effective strategy to remove structural impediments to growth, the US economy may be mired in Japan-style long-term stagnation and face tough policy trade-offs for the rest of the decade. US competitiveness has been hampered by a crumbling infrastructure and an education system that has failed to deliver the skills required by a job market that is no longer centered on manufacturing, leading to structural unemployment. Growing wealth disparities—notably after the 2008 crisis—are likely to aggravate the current political and economic polarization.

4.2. Eurozone

The main challenge for the eurozone is to convince markets that vulnerable countries' policies and the new rescue scheme are sufficient to restore public sector solvency without destabilizing the financial system. Otherwise, a breakup of the eurozone looms. Preserving the single currency calls for significant governance reforms that will ensure a common voice and vision and a more effective (and better coordinated) response to shocks in the future. In practice this may mean taking steps toward a German-centered fiscal transfer union, with binding rules and sanctions (including exit strategies), as well as the controversial issuance of common eurozone bonds.

The eurozone is facing the choice of either reforming or becoming a marginal player on the global scene. A medium-term strategy to boost growth prospects would require the successful implementation of structural reforms that would improve competitiveness in Southern countries, address demographic challenges in Northern countries, and strengthen the eurozone banking sector through recapitalization.

4.3. China

The main challenge for China is to rebalance growth toward domestic consumption and labor-intensive activities. This calls for a flexible exchange rate regime, as well as policies aimed at boosting household incomes and curbing overinvestment. Given the decline in credit quality during the post-crisis credit boom, addressing banking sector risks is also a priority; local governments borrowed heavily during the boom and have invested in questionable construction projects, raising the risk of property bubbles and bank defaults.

In the short run, the focus is on controlling inflation and generating sufficient growth to maintain social stability during the transition to a new leadership. A slowdown in the developed world is likely to complicate this task.

5. Illustrative scenarios for the global economy

Against this background, this paper will develop illustrative medium-term economic scenarios for the post-crisis global economy. The proposed scenarios are based on alternative policy developments throughout the decade in the key global players—United States, European Union (with focus on the eurozone), and China.

The debt crises in the eurozone and in the US dramatically feed into each other. A loss of confidence in sovereign debt sustainability in the US and in the eurozone could have huge negative impact worldwide, both via the trade channel and the financial channel. Given US financial sector dominance, a slowdown (or another recession) would impact the world economy mainly through the US bond and equity markets. The situation in the eurozone is more volatile, and potentially very damaging in the short-term: an escalation in the debt crisis, with contagion to core eurozone countries, could precipitate a global financial panic worse than the 2008 crisis.

5.1. Benchmark scenario: Japan-style economic funk on a global scale

This scenario assumes the continuation of current muddling-through policies that do not address core global economic problems. The end-result could be a Japan-style decade of anemic global growth, with high unemployment in developed countries.

In the US, growth prospects would be constrained by drawn-out deleveraging, paralyzed fiscal policy, ineffective monetary policy, and limited scope for export growth. Under these circumstances, economic policy would fail to revive the economy during the next few years, as deleveraging would continue to proceed at a slow pace, and uncertainty would continue to discourage private investment, notwithstanding strong corporate balance sheets. The FED would "consider all options", after initially trying to reassure markets through an unprecedented "time commitment" policy that guarantees interest rates near zero for two years. However, given the depth of the recession, this strategy would at best lead to sluggish growth

later this year, as the economy recovers from the headwinds of the first semester (the Japanese tsunami, the spike in commodity prices, and the escalation of the eurozone debt crisis). With the expected continuation of budgetary cuts in state and local governments, employment is unlikely to pick up any time soon.

In Europe, the reactivation of the ECB bond-purchase program would buy some time until the extension of EFSF powers is ratified by eurozone parliaments in late September. Notwithstanding some positive noise from political leaders, no major change would be made in the eurozone governance frameworks beyond the establishment of yet another revised pact, with rules and sanctions that are unlikely to bite. Therefore, the risk of contagion to core countries would remain alive, requiring continued ECB support and additional IMF financing. The combination of weak US demand, fiscal contraction in peripheral countries, and a weak banking system would produce only modest growth in the eurozone throughout the decade.

The slowdown in China's main export markets would dampen domestic growth, putting pressure on the new leadership. Concerns with inflation and banking system weakness would limit their ability to implement another round of stimulus. In addition, declining commodity prices (resulting from current weak global growth) could reduce the demand of commodity exporters for Chinese goods. A slowdown in China, in turn, would negatively affect the rest of the world through the trade channel, with especial impact on commodity exporters that have benefited from the Chinese boom (such as Brazil and Australia).

On the positive side, this scenario could contribute to correct global imbalances. The global downturn could encourage Beijing to focus on domestic consumption, paring down unsustainable investment and allowing the Yuan to appreciate further. While the associated decline in purchases of US treasuries would complicate US deficit financing, these policy adjustments would represent a positive step toward reducing China's massive trade surpluses and rebalancing global growth.

5.2. Optimistic scenario: folden growth age redux

This scenario is predicated on a solution for the current political credibility deficit. Global growth prospects could be significantly improved if political leaders managed to set aside their differences and put in place credible strategies for the resolution of the short-term debt crisis in the eurozone and the long-term debt crisis in the US.

In the US, a virtuous circle would be created with the approval of a credible medium-term fiscal consolidation plan before the end of the year. This common-sense formula so far rejected by the political parties would include tax and entitlement reforms and a strategy for households deleveraging. The vigorous private sector response to these measures would rekindle economic growth; investment would pick up on the strength of healthy corporate balance sheets, while lower commodity prices would lift household incomes and encourage consumption. The removal of uncertainty (including good news from the eurozone) would boost medium-term growth prospects, with positive impact on the global economy.

The debt crisis in the periphery would end up by pushing the eurozone toward more integration. The ECB bond-purchase program, followed by the successful ratification of the revamped EFSF, would avoid contagion to core eurozone countries. Under pressure from jittery financial markets, eurozone leaders would manage to agree on significant governance changes, moving toward a political and fiscal union, including a eurobond regime. This would ensure an orderly resolution of the sovereign debt crisis, based on restructuring of peripheral countries' debt. At the same time, eurozone competitiveness would be boosted by an acceleration of structural reforms in the periphery and union-wide bank recapitalization. Growth prospects would also be enhanced by positive developments in the US.

China's exports and international reserves would initially decline on the heels of the global slowdown. However, the new leadership would react positively to fragility in the world economy by taking concrete steps to strengthen household incomes and boost domestic consumption. The policy package to rebalance growth

would include a more flexible exchange rate policy, interest rate liberalization, and improvements in the social safety net. Overtime, successful implementation of these policies would ensure a smooth transition to a consumption-led growth path, with positive impact on the global economy (mostly via trade).

On the downside, robust global demand by the end of the decade could lead to renewed pressure on natural resources, with environmental and social consequences. The end-result would depend on the development of energy-saving technological innovation, including by emerging markets.

5.3. Pessimistic scenario: doomsday for the global economy

This scenario assumes a protracted political economy crisis in the Western democracies. The short-term risks from the eurozone debt crisis would explode into a full-blown systemic crisis. Given the underlying weakness of the US economy, robust growth (and better fundamentals) in emerging countries would not be enough to save the global economy from tanking, leading to a resurgence of protectionism and global economic stagnation for the rest of the decade.

In the US, political gridlock would result in medium-term budgetary cuts based on sequestration of discretionary spending, without tax/entitlement reforms. At the same time, the removal of short-term stimulus, combined with bad news from Europe, would tip the economy into a double-dip recession. Discouraged by continued uncertainty, private investors would continue to sit on piles of cash. With no political space for additional fiscal stimulus, the FED would start another round of quantitative easing. However, Q3 would be less effective than its predecessors in jumpstarting economic growth and boosting employment. At the same time, easy monetary policy would further weaken the dollar and encourage destabilizing capital inflows to emerging countries, reviving the currency wars and igniting worldwide protectionism. Overtime, the lack of dynamism in the US economy would lead to economic stagnation and to the loss of global reserve currency status by the US dollar.

In the eurozone, political paralysis would lead to a partial breakup of the monetary union. Without credible action to revamp governance mechanisms, the current sovereign debt problems in the periphery would spill over to core countries, raising risk premia in the eurozone. This would be followed by disorderly defaults and/or exit of some countries from the union, as well as banking distress, with large regional and global impact. In the extreme, this scenario could encompass a complete dissolution of the monetary union and a global banking crisis, denting Europe's global clout and growth prospects.

A downward spiral in the developed world would hit Chinese exports badly. This would be aggravated by reduced demand by commodity exporters affected by the global recession. China's reaction to the deteriorating global situation would be to resort to fiscal/monetary stimulus in order to boost growth and maintain domestic stability. This strategy only would aggravate its problems of overcapacity and inflation, seriously raising the risk of a domestic banking crisis and a hard landing, with large regional impact.

6. Non-synchronized scenarios

The high degree of interconnectedness of countries' growth prospects brought about by globalization makes non-synchronized scenarios less likely. Nevertheless, it is useful to explore the implications of bifurcated paths for the key global players for the rest of the decade.

6.1. G-2 virtuous circle

Positive economic developments in the US and in China would strengthen the G-2 and the world economy, despite relative stagnation in Europe. The political process in the US would, after an initial struggle (most likely after the next presidential elections), deliver the structural reforms necessary to restore the long-term competiveness of the US economy. Growth would pick up steadily, inter alia on the strength of exports to booming non-European emerging markets. At the same time, despite short-run pressures from higher inflation and policy tightening, China would

continue to grow fast, while gradually adopting policies aimed at rebalancing growth toward domestic consumption, including more exchange rate flexibility. As a result, the current account imbalances in both countries would be drastically reduced by the end of the decade, with positive impact on the rest of the world. This scenario would produce a new bi-polar global economic and political order around the G-2.

6.2. A hard landing for China

In this scenario, China would not be able to avoid a hard landing, while the advanced economies would be stuck in Japanese-style low growth as in the benchmark scenario. To make up for the loss of export markets and avoid social tensions at home, policymakers would press on the accelerator, notwithstanding rising inflationary pressures. Despite the very high investment/GDP ratio (now around 50%) fixed investment would continue to grow, adding to overcapacity, fueling inflation and housing bubbles, and aggravating the non-performing loans problem. Ultimately, the excessive investment policies (including the implied massive transfers from households to state enterprises) would become unsustainable, leading to a banking crisis and a sharp economic slowdown.

6.3. Developed world struggling, developing world booming

In this scenario, robust growth in emerging and developing countries would be sufficient to offset the weak performance of advanced economies. Despite tepid growth in rich countries, growing trade between developing and emerging countries would generate sufficient stimulus to promote convergence with the developed world and ensure steady global growth. Moreover, lower food and energy prices resulting from the slowdown in advanced economies would ease inflationary pressures. This optimistic outlook is motivated by the improved macroeconomic situation in developing and emerging countries, following economic liberalization and structural reforms implemented during the 1990's, as well as their recent growth performance. However, fast growth by and large has come on the heels of strong capital inflows or commodity booms—conditions

that may not be replicated in the near future. Ultimately the potential for sustained growth in emerging/developing countries hinges on the steadfast implementation of politically challenging structural reforms, which is by no means guaranteed.

7. Concluding remarks

In this era of high economic anxiety, crystal balls are becoming foggier by the day. But it is safe to say that the recent accumulation of negative economic and political news has heightened the risk of a more extreme negative scenario for the global economy for the rest of the decade. In the developed world, uncertainty is likely to persist until investors, consumers, and businesses regain faith in the political elite and their policy frameworks. This will depend largely on policymakers' ability to deliver politically-divisive but durable solutions, rather than quick-fixes. Another critical variable for favorable global prospects is the capacity of emerging countries to carry the world economy while the advanced economies recover from the 2008 crisis and struggle with high debt burdens. This will be tested in the years to come.

In all scenarios, the post-war move away from a single center of gravity for the world economy is likely to continue. But the precise configuration of the new multipolar order, including the relative importance of the major players in this fragmented world, would depend on which scenario ultimately prevailed by the end of the decade. The recent experience of political drift in advanced Western economies while the G-20 is missing in action suggests that global governance in a multipolar world will continue to be challenging.

Current trends are testing the resilience of the American economy. But a sharp US decline is far from certain, as it retains the lead in innovation, and can count on favorable demographics. The recent gradual shift in wealth and economic power from West to East could still be reversed (at least partially) with a revitalization of the US economy if policymakers manage to put the economic house in order. But in this interconnected world, much will depend on the performance of the other key players.