A FRAGILE AND FICKLE RECOVERY

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Framing the Issue

As leaders gather later this month for the G-20 Summit in Los Cabos, Mexico, fears continue to loom over a world economy that remains on life support, largely provided by accommodative central banks.

Concerns about spillovers from a worsening of the European debt crisis and slowing growth in key emerging markets are putting a damper on consumer and business confidence. Equity markets have pulled back from a robust performance in the first quarter of this year as the sobering reality of a continued anemic recovery dampens investors' optimism.

At the upcoming summit, leaders of both advanced and emerging market economies must show that they have the political resolve and will to implement the necessary policies in their economies to restore confidence and bolster domestic demand.

Policy Considerations

Following a brief surge in activity, the world economy is once again beset with worries about risks on multiple fronts. Looming risks and the lack of policy space in advanced economies are taking a toll on economic activity as well as confidence.

In advanced economies, there is considerable uncertainty about what room is left for aggressive policy responses to counteract weak demand and, in any case, whether those measures will get much traction. With fiscal policy already in a tight spot and monetary policy out on a limb in these economies, the room to boost domestic demand is limited.

The eurozone debt crisis remains the major source of global risk and will undoubtedly be a top priority item for the G-20 agenda. Many European economies are being forced to restructure their public finances even as they venture to undertake massive structural reforms. This is stifling growth, worsening debt-to-GDP ratios in the short run, and generating an unsustainable political situation at the domestic and pan-European levels.

Among advanced economies, the U.S. economy remains one bright spot but there are few others that show signs of self-sustaining demand growth. The U.S. recovery is gradually firming up but remains fragile. Output growth has been modest at best but the unemployment rate continues to drop and employment growth has begun to pick up, even if haltingly and at a pace that still leaves total employment below its pre-crisis level. Equity markets have held up moderately well while credit growth is picking up, helping to give consumer and business confidence a small but noticeable boost.

Japan remains mired in weak growth while the U.K. is now officially in recession. Many countries in the eurozone are in recession as well; France is on the edge of recession, and even the mighty German economy is showing signs of stumbling.

Emerging markets continue to perform better than advanced economies but their growth momentum is also slowing.

China's growth outlook has darkened as the economy continues to be buffeted by domestic policy challenges, an unexpectedly rocky political transition, and uncertainties in the global trade and financial environments. If growth were to slow sharply, China has room to respond with aggressive expansionary policies. A good balance of fiscal and monetary policies is necessary, but there are signs the government may again resort to a credit-fueled investment surge. This would secure short-term growth but could set back the long-term goal of rebalancing economic growth and making it less reliant on investment.

India has hit a rough patch, with industrial production growth hitting a wall, output growth slowing sharply, and the current account deficit widening and leaving the economy vulnerable to capital flow reversals. Brazil, Russia, and most other emerging market economies have also experienced slowdowns in GDP growth, with industrial production growth taking a sizable hit. In many of these economies, monetary policy is facing a difficult balancing act between maintaining growth and holding down inflation, with inadequate support from fiscal policy.

Financial markets around the world posted a strong performance in the first quarter of 2012 as it appeared that significant steps were finally underway to tackle the eurozone debt crisis and the world economy had finally turned the corner. Developments in the eurozone and elsewhere have thrown cold water on this optimism, leading to a weakening of financial market indicators in recent weeks.

Action Items for the G-20

Four years after the financial crisis drove the world economy to the brink of collapse, the pervasive sense of imminent doom had given way to cautious and nervous optimism earlier this year. However, the global economic recovery is still sputtering due to a lack of robust demand, policy tools that are stretched to their limits and unable to muster much traction, and enormous risks posed by weak financial systems and political uncertainty.

A key priority for the G-20 now is to straighten out the mix of policies so that the entire burden of preventing cataclysm as well as supporting growth does not fall on monetary policy. The mix and timing of policies is necessarily country-specific, but in most countries fiscal policy and structural reforms will need to shoulder more of the burden in rebuilding confidence and reviving growth. Leaders must use the platform of the G-20 summit to show that they not only understand what needs to be done in their economies but also that they have a concrete plan to take the measures needed to restore growth and stability.