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What the world must do to sustain its convalescence

di Martin Wolf

So what did I make of this year's annual meeting of the World Economic Forum at Davos? It felt like sitting at the bedside of somebody who had survived a heart attack but was unsure how long it would take to recover full vigour, if, indeed, he would at all. The mood of "Davos men" (yes, they mostly still are) was, as my colleague, Gideon Rachman, has pointed out , one of anxiety. Meanwhile, the participants in a still predominantly western meeting looked at the youthful vigour of emerging economies with admiration, envy and even fear.

For me, the highlight of the programme was the economic outlook session on Saturday.* This is not only because I was moderator. The starting point for the discussion was an obvious one: the policy interventions of late 2008 and 2009 have been a resounding success. The outcome has been a far briefer and shallower recession than most participants imagined a year ago. That is obvious from the successive consensus of forecasts for 2010. For almost every significant economy, the forecast for growth this year is higher than it was a year or even six months ago (see charts). The world economy survived the heart attack in the financial system.

It did so as a result of fiscal and monetary stimuli that are unprecedented in peacetime. These actions were essential and successful. It was inevitable, in particular, that the largest increases in fiscal deficits occurred where the private sector's credit bubble had been greatest: the US, UK and Spain above all. China also mounted a massive stimulus programme, as Zhu Min, deputy governor of the People's Bank of China, noted in the discussion.

The big questions for this year are how quickly to withdraw the monetary and fiscal stimulus and which should be withdrawn first. In the wider world, there is immense pressure to start the tightening now. Some - particularly in the Republican party in the US - argue that, since the economy is not back to full employment, the stimulus failed and should be withdrawn at once. There is a far more plausible case that it was inadequate. But politics eschews counterfactuals: "we saved you from a depression" is not a vote-winning slogan.

In considering the exit strategy, I cited an ideogram invented by Sir Martin Sorrell of WPP: "LUV", which describes the shape of the recoveries of European, North American and emerging economies respectively. What needs to be done depends on the state of the various economies, with the case for continued stimulus strongest in Europe and weakest in rebounding emerging countries. That point was made by Dominique Strauss-Kahn, managing director of the International Monetary Fund. He also made another one: if we exit too late, we waste resources in excessive public deficits and debt; if we exit too soon, we risk the devastating shock to confidence of a "double dip". Given this asymmetry, we should not withdraw stimulus early.

Since Mr Strauss-Kahn represents the "it's mostly fiscal" IMF, his words carry much weight. There is still little evidence of a strong upsurge in private-sector final demand in high-income countries. So long as this remains the case, there is danger in a premature withdrawal of fiscal support. What is needed are credible medium-term plans for fiscal consolidation, but ones whose implementation depends on economic conditions. Meanwhile, monetary policy must remain supportive.

Yet exit is merely the most immediate challenge. Two somewhat longer-term tasks lie ahead: financial sector reform and durable rebalancing of demand in the world economy. On neither point could one depart Davos optimistic. Whatever its merits, President Barack Obama's unilateral announcement of the "Volcker rule" on proprietary trading was a shock, though some welcomed the renewed political impetus. Again, it is doubtful whether the "mutual assessment programme" launched by the heads of government of the Group of 20 in Pittsburgh last September will obtain the needed support. But far too many countries are relying on export-led growth as the way to balance their withdrawal of domestic stimulus. This is a recipe for stagnation. The Earth cannot, after all, hope to run current account surpluses with the people of Mars.

This leaves us with a big question: will it be possible to sustain an open world economy? Representatives of the emerging economies remained strongly in favour. But, as Nicolas Sarkozy, president of France, delighted in pointing out in his opening speech, the financial crisis has damaged the legitimacy of the global market economy in many western eyes. Indeed, he sometimes sounded like just another anti-globalisation protester. Lawrence Summers, Mr Obama's principal economic adviser, also stressed that "what we are seeing in the US and perhaps in other places, is a statistical recovery and a human recession". In his view, the combination of high unemployment with "mercantilist policies" in parts of the world makes it hard to defend liberal trade politically or perhaps even intellectually. Unless the recovery proves far stronger than expected, high unemployment will persist in western countries, with all the political dangers it brings.

The biggest challenges, then, are political. The world's leaders showed an impressive ability to deal with the crisis. The will to co-operate last year, seen not least in the rise of the G20, was remarkable. But such co-operation becomes far more difficult as we return to politics as usual, particularly given high unemployment and deep political divisions inside the US, still the world's hegemonic power. The European Union remains ineffective. Indeed, the inability of the eurozone to address the fact that the periphery cannot escape from its fiscal trap without strong expansion in demand at the core is proof of that. China, too, is inward-looking. Mr Zhu promised rebalancing. But is that going to happen after today's stimulus measures are withdrawn?

We have a globalised economy, but politics remains local. In times of crisis, the pressure to look after the former dominates the latter. But now we face a different task: that of convalescence and the associated return to politics as usual. Nobody can imagine that managing this transition will prove easy. But, as the global balance of power continues to shift year by year, the challenge must be met. If it is not, the global economy and global co-operation might yet founder. This is my principal lesson from Davos.