

## KEY POINTS

- **Strong economic activity in the United States is leading global growth, but overall, the world economy remains slow to accelerate and faces several potent risks.**
- **Key risks include the ever-approaching tightening of US monetary policy, a potential real-estate bust in China, inaction on stagnation and deflationary pressures in the euro zone, and lower potential growth due to high levels of debt and income inequality, among other factors.**
- **Commitments to boost growth and strengthen global resilience made at the Brisbane G20 Summit were encouraging, but uncertainty stands in the way of their implementation.**

Harold James is a CIGI senior fellow. Domenico Lombardi is director of CIGI's Global Economy Program.

## A DISAPPOINTING NEW YEAR!

One word describes the global economy in 2014: disappointment.

In October, the International Monetary Fund (IMF) cut its outlook for global growth to 3.3 percent, extending a pattern of missed forecasts that dates to 2011. The IMF foresees better days in the new year. That is possible, but the cautious optimism should not be taken for granted. The headwinds that impeded progress in 2014 are still blowing hard.

Only the United States (and perhaps the United Kingdom) provides some grounds for optimism. The world's largest economy sputtered for much of 2014 before coming to life over the final months of the year. The unemployment rate dropped to the lowest in more than six years and equity markets touched record levels. Faster growth will prompt the Federal Reserve to raise interest rates in 2015, which could cause volatility and spillover into bad effects on other markets. Fed officials can reduce this risk by telegraphing their intentions, and their high standard of communications of late suggest they will do so.

China desperately needs more balanced growth: investment has increased 355 percent since 2000, while household consumption increased only 173 percent. There are legitimate fears of a real-estate bust and hard landing. Yet China's government has a large capacity to absorb shocks, and officials showed in 2014 that they are willing to keep the economy from decelerating too quickly. Beijing has its work cut out, but so far it has been able to forestall the worst.

European authorities cannot say the same. As a disinflationary trend became entrenched, fiscal authorities clung to austerity programs and the European Central Bank (ECB) continued to debate the merits of sovereign quantitative easing (QE) — the creation of money to buy financial assets. Europe's deflationary pressures emanate from stagnant growth, high unemployment, fiscal constraints and financial fragmentation. None of these are temporary shocks. Politicians, central bankers, employers, unions and banks must all mobilize their resources to end the region's economic stagnation. The ECB, for the most part, was a lone actor in 2014. It cut interest rates to the zero lower bound, and it introduced a new targeted lending program for banks.

Yet banks failed to show up for the new capital in great numbers, and borrowing costs were already at record lows. The ECB may resort to QE this year, but probably not that soon. It is also unclear whether doing so will have much effect. With money already cheap, the ECB will have to ensure any QE program boosts confidence and erase expectations that low inflation is a long-term phenomenon.

German authorities are unlikely to support a radical version of sovereign QE. Any plan is going to be limited, the opposite of what the euro zone really needs at this juncture. Some ongoing developments in the euro zone are also not helping. In Italy, Standard & Poor's downgraded sovereign bonds to BBB-, the lowest investment grade. In Greece, political instability has resulted in early elections later in January, which might lead to the radical opposition movement Syriza forming a new government. For Mario Draghi, the ECB president, it is going to be even more difficult to make the case for euro zone-wide government bond purchases, as the rating divide has been widening among some countries, not narrowing, and political uncertainty is on the rise.

Yet, other options are falling short for the ECB. It tried to expand its balance sheet by providing large amounts of funding to the banking system, but results have been mixed at best. It now aims at the private sector's purchases, but given the size of the target markets, its effectiveness is going to be limited, albeit still helpful.



Another option would be to buy foreign assets. The ECB (like the Fed) has not been significantly active in the foreign exchange market and has consistently maintained that the euro is market-determined. However, in this case, the narrative could be that the ECB buys foreign assets as a part of a multi-pronged approach aimed at expanding its money supply. In the aftermath of the international financial crisis, the dollar depreciated significantly vis-à-vis the euro, but the US authorities maintained that it was the side effect of a broadly accommodative monetary stance rather than the result of a deliberate beggar-thy-neighbour strategy. Along similar lines, the Japanese yen has depreciated as a result of the hyper-expansionary monetary policy engineered by Governor Haruhiko Kuroda of the Bank of Japan.

For the euro to target one currency, say, US-denominated assets, would be considered a hostile act in Washington. This is why a broader purchase strategy targeting a broader set of currencies, including the ones that are not in the special drawing right basket, such as those of major emerging markets, might be desirable.

For this to work, broader consensus within the Group of Twenty (G20) might be needed. Turkey — the new chair of the G20 — has pledged to keep the commitment of the outgoing Australian chair in putting growth and international economic cooperation at the centre of the G20 agenda. This might just be the test case.

The euro zone is hardly alone in facing a stagnant economy. The possibility that the global economy's potential to grow has been permanently reduced by higher debt levels, income inequality and other factors, rose to the top of the G20's agenda in 2014. In Brisbane, Australia, leaders pledged to boost economic growth by focusing on labour markets and investment. By the standards of the G20, the commitment was surprisingly solid; however, domestic political conditions will test the G20's ability to deliver. Strong governments in Australia and Germany should allow those countries to follow through. The leaders of the United States, France and Italy face difficult legislatures and the United Kingdom and Canada will have elections in 2015. It remains to be seen how much of the G20's careful planning will be turned into action.

Fragile financial and commodity markets also complicate the economic backdrop. The sharp drop in oil prices at the end of the year is a mixed blessing. Lower fuel prices should boost consumption. The decline will also cause strain in nations that export oil. Russia, which was already suffering from economic sanctions, is on the verge of a recession. Its political leaders may hope that the fallout and spillover from its crisis will act as a punishment for the countries that agreed sanctions.

Any assessment of the state of the global economy heading into 2015 must acknowledge that the financial crisis of 2008 is gradually receding into the past. Unfortunately, this isn't saying much. The global economy appears to be accelerating, but at a slow pace. New vulnerabilities have built up, and there is still much that could go wrong.