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Global Contagion Without a Response

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The world economy really seems to be spinning into its most worrying scenario, that of a synchronized global downturn. As long as there were one or more cylinders firing – whether Chinese, from other emerging markets, or possibly even the USA – there remained the prospect of a locomotive capable of hauling even the weaker wagons, such as Italy, out of recession.

Now, the much dreaded contagion has not been contained to within the euro area, but has spread to the four corners of the globe. Even though it would be misleading to attribute each and every slowdown to the euro crisis, there is no doubt that the latter is now the heaviest noose around the world economy's neck. For some time now, the main international institutions, from the International Monetary Fund to the OECD, have been pointing to the euro crisis as the main risk to the world economy, responsible for the repeated downward revisions to growth forecasts. More recently, there has been a clear crescendo of such institutional alerts. Two weeks ago, at the conclusion of the IMF's mission to the euro area, its Managing Director Christine Lagarde warned, in unusually strong terms, of the risk of sizeable global contagion from any further intensification of the eurozone crisis, and called for "a more determined and forceful collective response." And again yesterday, at the end of the annual consultation discussions with the U.S. authorities, Ms Lagarde pointed to the European crisis as among the major brakes to the U.S. recovery. The concern appears upfront, in the opening sentence of the IMF mission's findings: "The U.S. recovery remains tepid and subject to elevated downside risks, in light of financial strains in the euro area and uncertainty over domestic fiscal plans."

The IMF intervened yesterday with similar tones also on Germany, releasing the conclusions of the Executive Board's annual examination of the German economy. Here too, the outlook was seen to be clouded by downside risks, including an intensification of the euro area crisis and potentially lower global growth prospects. Against this background, IMF Executive Directors urged the German authorities to "implement policies to spur domestic demand growth, which will have important beneficial spillover effects in the euro area and globally" Significant German banking risks were also noted, as institutions remain "highly leveraged, dependent on wholesale funding, have low capital quality and profitability, and some institutions are significantly exposed to the euro area periphery." Hence the call for "greater efforts to restructure Landesbanken," the influential regional banks. In this context, one can only hope for a speedy and effective implementation of the euro-wide banking supervision agreed at the last summit in Brussels, with oversight extended also to such institutions.

These various institutional warnings have been buttressed by an uninterrupted series of negative data coming out of the main countries which, it was hoped, would act as the world's growth engines. Starting from Germany, where manufacturing activity (as measured by the PMI) contracted last month at the fastest pace in three years, with new orders declining for the twelfth consecutive month. While there is nothing to rejoice in such news, there's at least hope that when the pain inflicted by the euro crisis begins to be felt within Europe's core, it will act as a wake-up call, helping to focus minds. But evidence of spreading pain is, unfortunately, even more widespread: not only in China (with a slowdown in manufacturing growth for the eighth month in a row), but also in India and Brazil. In essence, all main Brics are experiencing declining growth in industrial production, falling retail sales, and moderating inflation – in itself a welcome development, but still a sign of cooling economies.

Against this background, the absence of a global response is conspicuous. At the time of the Asian crisis, in February 1999, Time magazine featured a cover on "The Committee to Save the World" with the three "marketeers" (Rubin, Greenspan and Summers) credited with having prevented a global economic meltdown. At the time, U.S. leadership was evident – perhaps even overly so, but at least there was a sturdy reference point, a single crisis manager (a far cry from today's summits of 27 or 17, or from a "troika" riveted by internal divisions) that could direct the international community's response. Today we have instead a paralyzed U.S. administration, blocked by the polarization of a dysfunctional American political system, a dated G-7, and a G-20 still in the running-in phase. Central banks provide the only remaining instrument of intervention; they have done much and continue to be relied upon on both sides of the Atlantic – beginning with, hopefully, a reduction in intervention rates at the ECB meeting on Thursday. But, as is known, much more will be needed, starting with a rapid implementation of the decisions taken at the last euro-summit.