WHAT GLOBAL ECONOMIC RISKS DO WE FACE?

A conversation with Heather A. Conley, Matthew P. Goodman, and Scott Miller

GLOBAL FORECAST: Eight years after the financial crisis, let's take stock of where we stand. How are the economies in the developed West, emerging Asia, and other parts of the world performing? How do we expect them to perform over the next few years?

MATTHEW P. GOODMAN: The global economy is still not in a good place. Global GDP growth has disappointed relative to pre-crisis trends, averaging just above 3 percent per year since 2008. Even this modest level of growth has required an explosion of debt: the global debt-to-GDP ratio has risen almost 10 percentage points since the crisis. Trade growth, which used to comfortably outpace GDP growth before the crisis, has weakened significantly to just above 2 percent per year. Even in the United States, where job growth has been relatively robust, wages have only just passed their 1996 level.

All of this is taking place against a backdrop of enormous political uncertainty and rapid technological change. Either of these could bring further disruption. It's no surprise that business investment has been stubbornly subdued across the globe.

SCOTT MILLER: Most forecasters estimate global growth will be stuck at around 3 percent to 3.5 percent, with the United States delivering the same old 2 percent real growth for 2017 and 2018. Essentially, forecasts tell us to "embrace the boredom." Absent the capacity for a big dose of monetary or fiscal stimulus, slow growth is certainly better than none at all.

GOODMAN: Growth in emerging markets will be more robust, but it is neither strong nor likely to be sustainable. China is continuing its structural slowdown. Even if India maintains growth in the 7 percent range, no single country can drive regional growth.

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HEATHER A. CONLEY: Europe continues to be plagued by high levels of debt, weak growth, and a very fragile banking sector, which grows ever weaker from negative interest rates and the weight of nonperforming loans. Five Eurozone countries' debt-to-GDP ratio exceeded 105 percent at the end of 2015. Surprises could throw Europe's "muddle through" strategy off track, but we should also prepare for surprises with unanticipated upsides. For now, the economic impact of Brexit has not followed the predicted path of economic Armageddon.

GF: Looking at the current global economic landscape, what do you think are some of the key risks that policymakers need to be alert to? Could we see another downturn on par with what we saw in 2008? What about the reverse—do you see any underappreciated strengths? And what should policymakers be doing about all of this?

GOODMAN: The good news is that the major economies have done a lot to address the vulnerabilities in the global financial system that produced the last crisis. But even as greater resilience has lowered the probability of a 2008-style financial crisis, it would be hard to argue the risks are gone.

One risk is macroeconomic policy error. The U.S. recovery is still not especially strong, and the Federal Reserve should be wary of raising interest rates too quickly. In Europe and Japan, leaders should avoid the temptation to cut government spending too soon.

There are also looming financial risks. Europe needs to deal with a banking sector that is still too weak to withstand an external shock, as we saw when Italian banks wobbled after the Brexit vote. China needs to address mounting corporate debt and industrial overcapacity to avoid its own "lost decade."

More difficult for policymakers, but no less necessary, will be addressing structural constraints that both inhibit growth today and could lead to a crisis down the road.

CONLEY: In Europe, the risks are plenty. There are the anemic French and Italian economies, a banking sector too closely linked to government, high sovereign debt, high unemployment especially among youth, a looming demographic crisis, and increasingly protectionist and nationalistic instincts.

But Europe also has strengths that are underappreciated. The export-driven German economy continues to perform well, as does the British economy, Brexit notwithstanding. Europe has strong democratic institutions and predictable legal systems, globally desirable goods and services, a highly educated workforce, developed infrastructure, and a welcoming investment climate. This is why both American and Chinese firms find Europe so attractive as an economic destination despite its current economic woes.

MILLER: The U.S. and other advanced economies face more downside risks than upside at this point in the business cycle. The current U.S. expansion is 90 months old, longer than the post–WWII average of 56 months, and price inflation is headed up slowly. Interest rates remain extraordinarily low worldwide, but are unlikely to stay that way. The end of "free money"—whether it is a result of markets or the action of central banks—is a likely source of instability. Sovereign debt loads have increased dramatically since 2008, and debt service obligations will crowd out other fiscal measures.

Here in the United States, tax reform could provide incentives for stronger capital formation and productivity growth, which have disappointed since the 2008 recession. Absent real financial leadership, though, status quo politics will likely deliver no better than status quo growth.

GF: Europe was hit particularly hard in 2008. What are its prospects for recovery? There's no denying that its economic woes are having political implications. Can you give us a sense of how stagnant growth might lead to increased populism and nationalism, and how this might play out in elections across Europe and in the broader effort to hold Europe together post-Brexit?

CONLEY: Despite signs of recovery, the perception in Europe remains that the economy is stagnant. This creates palpable anxiety that wreaks political and economic havoc. To give you a sense of the anxiety, the European Central Bank has maintained interest rates near zero, but instead of encouraging spending, the net savings rate of households and businesses actually rose by 40 percent!

Juxtapose this with the fact that three-fourths of Eurozone economies will have national elections or referendums between now and the end of 2017. When anxiety meets popular will, the results can be unpredictable to say the least. This is what happened with Brexit, what happened with our elections, what is happening at present with the political chaos in Italy, and what could occur in 2017 with elections in France and Germany.

MILLER: It is a destabilizing brew—slow growth and high unemployment. With little room for additional monetary or fiscal stimulus.

GOODMAN: It is a fragile moment right now in Europe. France and Spain are recovering but both still face high unemployment. The UK faces great uncertainty depending on whether we see a "hard" or "soft" Brexit. The biggest obstacle to recovery in Europe is probably Germany, even though it continues to enjoy steady growth and rising wages. There will be limits to Europe's recovery so long as Berlin refuses to use more expansionary fiscal policy. But it has its own politics to worry about.

GF: Populist forces around the world are taking aim at trade as being skewed toward big business and fostering inequality. What is the best chance for rescuing a trade agenda and avoiding tariff wars in the years ahead? What should the G7 be doing?

MILLER: Venture capitalist and Trump supporter Peter Thiel summed it up in a recent speech at the National Press Club: "no matter what happens this election, what Trump represents isn't crazy and it's not going away." Mainly, the protectionist backlash evidences a failure of political leadership. But be-

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cause the forces behind the current turbulence are principally technological, it's important for leaders to recognize that policies that "worked" in a different environment may not be effective in the future. Technology, not policy, is the prime mover behind today's intensified inter-country competitiveness, and yesterday's trade or currency deals with advanced economies will not suffice.

The sliver of "good news" is that most Americans seem to understand that times have changed. Polls show steady support for trade and trade agreements despite harsh campaign rhetoric. Without question, arriving at new policies suited for a new reality will take time and energy. In the meantime, elected officials in the G7 and elsewhere should work to avoid "vandalism" to the current structure while accelerating an appreciation of how the "new" economy really works and how to address those new challenges with people, ideas, and effort.

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GOODMAN: Trade has become a scapegoat for an array of grievances relating to rapid changes in the economy and society. Like technological progress, more open trade brings broad and substantial benefits to an economy. However, it is also true that trade causes real disruption to some workers and companies. Governments have not done a good enough job on either side of this story: explaining the benefits of trade or addressing its adjustment costs.

Rebuilding support for trade and trade agreements begins with making greater investments in the domestic underpinnings of a strong and competitive economy, including infrastructure, education and training, and innovation. More assistance for workers disrupted by economic change—whether caused by trade or technological progress—is also needed.

CONLEY: One of the most vocal public expressions of European anxiety and uncertainty is a rising revolt against free trade, a catch-all issue for the disruptive nature of globalization. Populists have effectively channeled this fear and anxiety and sought to eliminate any form of compromise between international trade and national economic policies. As leaders such as France's far-right leader Marine Le Pen have stated: Are you a patriot or a globalist? According to Ms. Le Pen and other nationalists of her ilk, you cannot be both. G7 nations must create the policy space where "patriots" and "globalists" can claim success, which would mean that patriotism is redefined as a nation's ability to become more successful in a globalized economy and globalists alter how they conduct business and negotiate trade agreements to become more responsive to national and regional demands and developments. Both sides must change how they have done business for the past 20 years and find a new middle ground yet both sides appear to be digging their trenches ever deeper in preparation for a battle of attrition.

GF: How much does U.S. leadership matter? What would you say to someone who says, 'the U.S. president has little effect over the global economy, European politics, or populist forces around the world"?

GOODMAN: The United States remains an "indispensable nation" in global economic affairs. Our position as the world's largest market and a leading source of technology and capital gives us unparalleled leverage in encouraging pro-growth policies and championing an open, rules-based global economic order. You can see this at play in G20 meetings, where most countries play a passive role and wait for the United States to propose a course of action. Of course Washington doesn't always get what it wants, and needs support to solve most global economic challenges, but without U.S. leadership the global economic order would be far less stable, predictable, and successful than it has been for the past 75 years.

MILLER: The wave of "globalization" that began in the late-1980s was initiated by U.S. technological, political, and military leadership. Its expansion was supported by an economic architecture created and sustained by the United States and key allies. Millions were lifted out of poverty, yet no economy benefited more than our own, with its relative openness, strong institutions, and adaptive, entrepreneurial people. Globalization has now entered a new phase, but I am confident that, if anyone can figure out how to make it work in a mutually beneficial manner, it is the American people, driven by their ingenuity, sense of fair play, and drive to make things better.

CONLEY: As the largest Western economy, the United States must lead the way to regaining lost confidence. A strong American economy will strengthen Europe's economy. When political paralysis in the United States finally gives way, this will send a positive and powerful message to other advanced countries that they can overcome their crises. Western confidence can be restored, but for the moment, populism and anxiety are in the ascendancy and Western confidence is in retreat. □

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