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# The Shifting Challenges in the Global Economy

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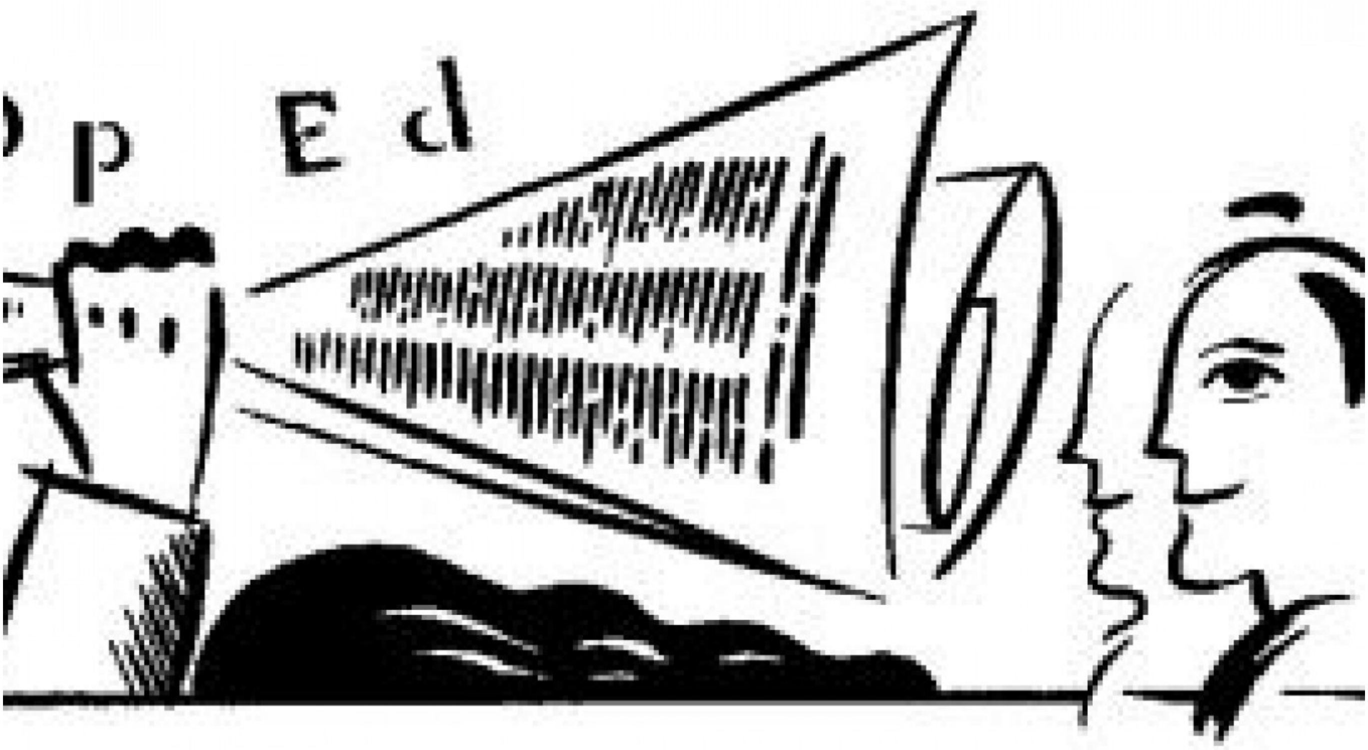


Efforts to revive growth in the world's most influential economies are having a beneficial effect worldwide, with the exception of the eurozone. All of the looming problems for the global economy are political in character.

After 25 years of stagnation, Japan is attempting to reinvigorate its economy by engaging in quantitative easing on an unprecedented scale. It is a risky experiment. Faster growth could drive up interest rates, making debt-servicing costs unsustainable. But Japanese Prime Minister Shinzo Abe would rather take that risk than condemn Japan to a slow death. And judging from the public's enthusiastic support, so would ordinary Japanese.

By contrast, the European Union is heading toward the type of long-lasting stagnation from which Japan is desperate to escape. The stakes are high. Nation-states can survive a lost decade or more, but the EU, an incomplete association of nation-states, could easily be destroyed by it.

The euro's design has a fatal flaw. Creating a common central bank without a common treasury means that government debts are denominated in a currency that no single member country controls, making them subject to the risk of default. As a consequence of the 2008 crash, several member countries became overly indebted, which made the eurozone's division into creditor and debtor countries permanent.

This defect could have been corrected by replacing individual countries' bonds with eurobonds. Prior to reunification, Germany was the main motor of integration. Now, weighed down by reunification's costs, German taxpayers are determined to avoid becoming European debtors' deep pocket.

After the crash of 2008, German Chancellor Angela Merkel insisted that each country should look after its own financial institutions and that government debts should be paid in full. Without realizing it, Germany is repeating the tragic error of the French after World War I. While French Prime Minister Aristide Briand's insistence on reparations led to the rise of Adolf Hitler, Merkel's policies are giving rise to extremist movements in the rest of Europe.

The current arrangements governing the euro are here to stay because Germany will always do the bare minimum to preserve the common currency — and because the markets and the European authorities would punish any other country that challenged these arrangements. Nonetheless, the acute phase of the financial crisis is over. The EU financial authorities have tacitly recognized that austerity is counterproductive and have stopped imposing additional fiscal constraints. This has given the debtor countries some breathing room, and even in the absence of any growth prospects, financial markets have stabilized.

Future crises will be political in origin. Indeed, this is already apparent, because the EU has become so inward-looking that it cannot adequately respond to external threats, be they in Syria or Ukraine. But the outlook is far from hopeless. The revival of a threat from Russia may reverse the prevailing trend toward European disintegration.

As a result, the crisis has transformed the EU from the "fantastic object" that inspired enthusiasm into something radically different. What was meant to be a voluntary association of equal states that sacrificed part of their sovereignty for the common good — the embodiment of the principles of an open society — has now been transformed by the euro crisis into a relationship between creditor and debtor countries that is neither voluntary nor equal. Indeed, the euro could destroy the EU altogether.

In contrast to Europe, the U.S. is emerging as the developed world's strongest economy. Shale energy has given the U.S. an important competitive advantage in manufacturing in general and in petrochemicals in particular. The banking and household sectors have made some progress in deleveraging. Quantitative easing has boosted asset values, and the housing market has improved, with construction lowering unemployment. The fiscal drag exerted by sequestration is also about to expire.

More surprising, the polarization of U.S. politics shows signs of reversing. The two-party system worked reasonably well for two centuries because both parties had to compete for the middle ground in general elections. Then the Republican Party was captured by a coalition of religious and market fundamentalists, later reinforced by neoconservatives that moved it to a far-right extreme. The Democrats tried to catch up to capture the middle ground, and both parties colluded in gerrymandering Congressional districts. As a consequence, activist party primaries took precedence over general elections.

That completed the polarization of U.S. politics. Eventually, the Republican Party's Tea Party wing overplayed its hand. After the recent debacle of the government shutdown, what remains of the Republican establishment has begun fighting back, and this should lead to a revival of the two-party system.

The major uncertainty today is not the euro but the future direction of China. The growth model responsible for its rapid rise has run out of steam.

That model depended on the financial repression of the household sector to drive the growth of exports and investments. As a result, the household sector has now shrunk to 35 percent of gross domestic product, and its forced savings are no longer sufficient to finance the current growth model.

There are some eerie resemblances with the financial conditions that prevailed in the U.S. in the years preceding the crash of 2008. But there is a significant difference, too. In the U.S., financial markets tend to dominate politics. In China, the state owns the banks and the bulk of the economy, and the Communist Party controls state-owned enterprises.

Aware of the dangers, the People's Bank of China took steps starting in 2012 to curb the growth of debt. But when the slowdown started to cause real distress in the economy, the Communist Party asserted its supremacy. In July, the leadership ordered the steel industry to restart the furnaces and the People's Bank to ease credit. The economy turned around on a dime. In November, the Third Plenum of the 18th Central Committee announced far-reaching reforms. These developments are largely responsible for the recent improvement in the global outlook.

The Chinese leadership was right to give precedence to economic growth over structural reforms because structural reforms, when combined with fiscal austerity, push economies into a deflationary tailspin. But there is an unresolved self-contradiction in China's current policies. Restarting the furnaces also reignites exponential debt growth, which cannot be sustained for much longer than a couple of years.

How and when this contradiction will be resolved will have profound consequences for China and the world. A successful transition in China will most likely entail political as well as economic reforms, while failure would undermine still-widespread trust in the country's political leadership, resulting in repression at home and military confrontation abroad.

The other great unresolved problem is the absence of proper global governance. The lack of agreement among the United Nations Security Council's five permanent members is exacerbating humanitarian catastrophes in countries like Syria or allowing global warming to proceed largely unhindered. But in contrast to the Chinese conundrum, which will come to a head in the next few years, the absence of global governance may continue indefinitely.

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