



New lows at Los Cabos?

Why expectations from the coming G20 summit should be low

When the leaders of the Group of 20 countries, or G20, meet at their seventh summit in Los Cabos, Mexico, on June 18, they might be struck by the sobering thought that the imminent threats confronting the global economy are, to all intents and purposes, the same they confronted at their last summit in Cannes, France, in November last year. If anything, these old challenges have become even more daunting.

The optimists would argue that this merely reflects the political compulsions of the current G20 presidency, on account of which two summits had to be held in quick succession. The pessimists would argue that this reflects poorly on the outcomes of the Cannes summit, which, despite a much-vaunted cooperative spirit and bonhomie, failed to adequately address these threats.

It is universally acknowledged that the Cannes summit agenda was hijacked by the gathering storm in the euro zone, specifically the Greek question. The summit failed to address the problem squarely. As a result, the contagion spread beyond the solitary PIG (Portugal, Ireland and Greece, all of whom had lost sovereign market access before Cannes) to the bigger euro-zone economies of Spain, Italy, even France. Their sovereign bond spreads started spinning out of control within weeks of the summit. It was the European Central Bank that rescued the euro zone, with the salvos (long-term refinancing operations) of “Big Bertha” battering sovereign bond markets into submission. Now that “Big Bertha” has fallen silent, sovereign bond markets are again in revolt, with the spreads of Spain breaching the dreaded six per cent barrier, and Italian yields in hot pursuit. (Surprisingly,



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French yields have drifted south following the leadership change there.) Leaders would now have to confront a much worse situation in the euro zone at Los Cabos, with governments quietly planning for the exit of Greece, or even a catastrophic break-up of the monetary union. The euro zone once again threatens to hijack the G20 agenda at Los Cabos.

The second threat facing leaders at Cannes was the dilemma of having to choose between austerity (market-induced fiscal consolidation) and growth (fiscal expansion to bridge the output gap). It tried to resolve the dilemma by making a (false?) dichotomy between the short-run (stimulate) and long-run (consolidate) continuum. By messaging that those who had the fiscal space should stimulate, and those who did not should consolidate, it sent out the rather perverse message that countries should continue to stimulate their economies till they are disciplined by markets, at which point they would need to consolidate irrespective of the output gap. While the flight to quality – sovereign bonds – seems to have created an illusion of fiscal space in a number of advanced countries to enable them to continue to stimulate, or stagger their consolidation, leaders seem to have left the recovery in the euro zone hostage to markets. The dilemma that will confront the leaders at Los Cabos will be even more acute, as electorates have joined issue with markets, voting against austerity by unseating governments wherever elections have been held. They would be expected to devise a coordinated workable strategy to revive flagging global growth, with markets and electorates revolting in different directions.

The third threat facing leaders at Cannes was the fal-

tering global recovery and the persistence of high levels of unemployment, particularly youth unemployment. The Cannes Action Plan was subtitled “Growth and Jobs” because unemployment had become a political hot potato, with the concerns over growth, global imbalances and exchange rates stemming primarily from this. If the sleight of hand in the employment data is discounted to take stock of discouraged workers who have abandoned their job search, and thereby by definition not being unemployed any more, the employment scenario has only worsened in most parts of the developed world since Cannes. Growth and jobs will, therefore, once again be near the top of the Los Cabos agenda, especially with near-term economic data from the US, the UK, the euro zone, and even major emerging markets like China, Brazil and India pointing towards another synchronised downturn.

The fourth threat to the global economy apparent at Cannes was the volatility and buoyancy in oil markets which were out of step with the depressed state of global demand and confidence, and which threatened to derail the recovery in emerging markets. This threat not only remains as strong as it was at Cannes, but is possibly graver on account of a new threat of a supply shock emanating from sanctions against Iran.

So what has changed materially since Cannes? Firstly, Spanish, Italian and French sovereign bond yields rose after the Cannes summit, but are now rising prior to the summit. Secondly, while there is now greater confidence that the current account surplus of the country accounting for the biggest global imbalance, namely China, may have shrunk permanently, this is countervailed by the realisation that the biggest source of global imbalances has now shifted to the oil exporting countries (mainly Opec, Norway and Russia). The G20 would need to devise a new strategy to deal with this new imbalance. Thirdly, with electorates revolting against austerity, the credibility of G20 commitments will be closely scrutinised by markets.

The Los Cabos summit would also need to address three important sensitivities. First, Germany is unlikely to take kindly to the G20 meddling with what it considers to be an internal matter of the euro zone, thereby undermining the G20’s new halo as the principal forum for global economic cooperation. Second, Mexico’s overarching focus on “green growth” is in the cross hairs of its American neighbour, Brazil, which feels that this would undermine their Rio+20 summit to be held immediately after the G20 summit. Third, China is peeved with the G20 not giving it due credit for its rebalancing efforts.

Such daunting challenges and sensitivities call for global leadership and statesmanship of a high order, of the kind displayed by the US and the UK (recall Gordon Brown and the trillion-dollar London summit) in the immediate aftermath of the global financial crisis. This appears unlikely at this juncture as the big three of the G20, namely the US, Germany and China, face elections and/or the prospects of a leadership change within a year of the Los Cabos summit.

While the medium-term agenda of the G20 is progressing satisfactorily, the outcome of the Los Cabos summit is likely to be assessed on its ability to effectively address these four big imminent threats. With an apparent crisis of leadership, nobody is holding their breath at what the outcome from the seventh G20 summit would be. The expectations from Los Cabos now appear to be so low that the summit can only surprise on the upside, not on the downside.