The divisions between East and West will be highlighted in Washington
DENNIS FLAHERTY/GETTY IMAGES

We must spend more

Gerard Lyons: Viewpoint

Monday September 19 2011, 1.01am, The Times

This coming week is one of the most important in the global economic and financial calendar. Central bankers, finance ministers, economists and bankers will gather in Washington for the annual meetings of the International Monetary Fund and World Bank.

These meetings occur in an environment of a divided and disconnected world that is facing significant policy dilemmas. There are many divisions, particularly between the East and West and also the core versus the periphery of Europe. The biggest disconnect is the high global rate of youth unemployment.

There should be much to focus on in Washington. The economic outlook depends on the interaction between the fundamentals, policy and confidence. In the US, UK and much of Europe the fundamentals are poor, the policy cupboard is almost bare and confidence has been shot to pieces. In contrast, across much of the emerging world, the fundamentals are better, the policy cupboard is half-full and confidence should prove far more resilient.

This week there is a huge opportunity to focus on policy issues and restore confidence. Global policy co-ordination is critical and far better than each country pursuing its own goals. The trouble is, in recent months disagreements have been evident over fiscal policy and currencies. In the euro area there are also tensions over monetary policy. This is not good.

It is unlikely that a magical solution will be found in Washington. There is no easy way to cure the overhang of debt and the need to deleverage in the West.

In the past these annual meetings were associated with sorting out the problems of crisis-hit countries from across the emerging world. In some respects this year is just like old times. The difference is that on economic fundamentals the biggest emerging markets in the world are now the US, UK and those in southern Europe. All have high debt, growing income disparities, dependency cultures, rising unemployment and economic imbalances. Some, like Greece, do not even bother to collect tax revenues properly.

Now, the boot is on the other foot, as China and India, among others, are growing strongly. If ever one needed evidence of the shift in the balance of economic and financial power, it is now.

The trouble is that as investors search for safe havens, no one is immune. In an era of globalisation, problems in one part of the world soon spread elsewhere.

Before the crisis in 2007 Asia and other regions such as Latin America and the Middle East were not decoupled from events in the West, but they were better insulated. This allowed them to rebound strongly, helped by high reserves and sound fiscal positions. Again, they are not decoupled from the crisis hitting the West, but they are diversified and better able to cope.

This diversification is seen in two-ways.

One is the growth of New Trade Corridors, with increasing flows in what would have once been called South-South trade.

The other is the resilience of domestic demand, as a new middle class emerges around the world. Although this is good news, in a bizarre way it adds to near-term problems in the West as firms there with the money to invest may think twice about doing so at home. Instead they may be tempted to invest in Asia and other growing regions.

Just as it is vital not to underestimate near-term challenges in the West, one should not overlook the longer-term positives in the East. Given this tale of two worlds the following actions are needed in Washington.

First, policymakers in the euro area need to get ahead of events. It may be too late to prevent Greece from defaulting and leaving the euro. Instead the core, led by Germany, needs to make it clear that they will support the rest of the euro area, to limit contagion.

Second is the need to address demand destruction in the West. Rising unemployment, sluggish wages, fragile equity and housing markets suggest a poor outlook for consumer spending. Tightening fiscal policy compounds this problem.

The IMF needs to press countries to spend in a way that makes sense and which keeps the markets onside. This is not easy but President Obama's recent jobs package shows it is possible.

The UK should be encouraged in Washington to boost infrastructure spending. This could be funded by thematic bonds, linked to the project for which the money is needed. The Chancellor has achieved credibility but low yields should not be an end in themselves, even allowing for the reduction in debt servicing costs they achieve.

Other countries, too, should be persuaded to boost demand. Of the big saving regions, China and the Gulf are spending. Perhaps they could do even more, as must Germany and Japan.

Third is the need to prevent currency wars. This was not addressed at the recent G7 meeting in Marseilles. It can be addressed only by the G20. Asian currencies need to appreciate that.

The West, meanwhile, must avoid competitive devaluations.

The risk is that politicians, fearful of being unpopular at home, may not take the decisive leadership necessary. Let's hope in Washington there is some progress, as the biggest problem the world faces is a lack of demand.

Gerard Lyons is chief economist at Standard Chartered Bank.

Comments for this article have been turned off