

Global Economy: Heading into a Perfect Storm?

“A Perfect Storm” is how Nouriel Roubini recently characterized the prospects for the global economy. In the European Union, a major crisis seems to be brewing in Greece. At the time of writing, several members of the ruling Socialist Party had resigned on the issue of the austerity plan aimed at cutting the budget deficit by € 78 bn over the next five years. The cabinet is being reshuffled, and the plan would need to be approved by Parliament before the EU agrees to release a €12 bn tranche under the existing package, hopefully over the weekend. There is escalating social unrest in Greece with riots, strikes, and demonstrations on the streets. And, the CDS premium has shot up to almost 20%. Rating agencies have downgraded Greece to CCC! Greece apart. Ireland too needs more assistance. Howsoever these problems are resolved, increasingly it looks like that the choices are narrowing down to an even closer integration through a zone-wide fiscal policy; *or* some countries leaving the euro (but there are too many political, technical and practical issues involved); *or* re-structuring of the debt of some of the weaker countries. Greek bonds aggregating an estimated €100 bn are held outside Greece, mainly by banks within the euro zone, and the European Central Bank.

But leaving the problems of the euro zone aside, there are enough signs that the two largest national economies globally, namely the U.S. and China, are slowing down. As for the U.S., GDP growth had dropped to 1.8% in the first quarter of 2011, from 3.1% in the previous quarter. And, 2/3rds of the growth is accounted for by increased business inventories. This, obviously, is not a sustainable model and economists are downgrading the growth prospects. The monetary policy stimulus has not really helped; and unemployment remains close to 10%. QE2 is ending; and QE3 looks unlikely as pushing the string of monetary policy even more strongly seems unlikely to lead to a pick up in final demand. During the last few decades, real wages of a large proportion of the population have remained stagnant, even as the rich got much, much richer. The illusion of higher living standards and increased consumption for this segment required a continuous increase in house prices. This led to a major financial crisis until the real estate bubble burst; there are few signs that housing prices will start growing

again. The second was a “strong dollar policy” which led to ever greater consumption of imported goods, external deficits, and major global imbalances. Clearly, the consumer driven model of economic growth seems to need replacement. An export led growth is also unlikely: a recent report I have seen suggests that U.S. manufacturing labour costs per hour were 25 times more than China’s in 2008.

To add to the problems, fiscal deficits have reached unsustainable levels and there are few signs of a consensus between the Democratic and Republican Party leaderships on the issue. And, the Presidential election looming next year is unlikely to be conducive to constructive dialogue. Rating agencies have threatened a downgrade and the ceiling on federal debt would be reached in the next few weeks. While the dollar did strengthen last week on the back of the worsening situation in Greece, its external value is equally, if not even more, susceptible to Beijing’s policy on reserves deployment.

The Asian economy too is showing more and more signs of a slowdown. Turning first to the two largest, in China, the property bubble could well be on the point of bursting thanks to tightening monetary policy in response to rising inflation. (To be sure, even now it is at 5.3%.) Lending growth in China has come down sharply. New loans in the first five months of the year were 12% lower than the corresponding period last year, and down 40% compared to 2009! All this is hardly calculated to spur growth, which is falling. Japanese output is stagnant partly also as a result of the natural calamities it has suffered recently.

What about India? We too seem to be heading for slower growth, particularly after last week’s one more tightening of the monetary screw. While commenting on the last budget, I had argued that the numbers seemed to be based on a 14% growth in nominal GDP in fiscal 2011-12, consisting of 9% real growth and 5% inflation. At that time, I had said that, to me, 7+7 looks more likely than 9+5. One wonders whether one should be even more pessimistic now, given that governance and decision making are on the sidelines with senior ministers busy dealing with the blackmail of Anna Hazare and Baba Ramdev, and more recently in dealing with the political fall out of the fiasco in which negotiations ended. But more on the prospects for India in later columns.

Tailpiece: In West Bengal, during the initial couple of decades of Marxist power, militant trade unionism de-industrialised the economy; Mamataji seems to be bent on continuing the tradition through her land policies.

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