Where is the world economy headed

By S L Rao

For over a decade most of the developed world has lived with low interest rates, high government borrowings, rising government deficits, unemployment, and modest growth. Their cheap money benefited developing countries as well who received loans and investments which gave better returns and stimulated development in the poorer countries. Export oriented countries in South East Asia, Japan and China ran up growing current account surpluses and became creditors to the United States as they accumulated rising amounts of American Treasury bonds. These had low returns but made the USA the most indebted country in the world.

Countries like India which had kept their interest rates relatively high to combat inflation, found it attractive to borrow abroad as many Indian companies did. Many Indian non-residents arbitraged by depositing funds in banks in India. Indian foreign exchange reserves rose despite growing deficits in trade balance. India also further encouraged such volatile flows by opening routes that were free of capital gains tax (like Mauritius) and registering foreign financial institutions that could hide identities of remitters and investors. This helped Indian tax evaders to smuggle money out and bring it back through such routes to be laundered. India ran current account deficits that at times reached 3% of GDP and over but such volatile inflows added to India's foreign exchange reserves and provided cover for the deficits.

In the developed world and especially the USA the years of cheap and plentiful liquidity led to a boom in asset prices especially of real estate, to a declining savings rate and consumption on credit. Cheap Chinese goods helped the consumer splurge. The budget deficits and borrowings of the US government was reflected also in thefinances if its households. They also made China the largest creditor of the USA and added to its global clout.

After the economic collapse caused by the credit overreach by the financial sector especially in the USA, major new legislation was passed in the USA to prevent such a situation from developing again. There are questions whether the legislation can be implemented fully. The financial sector and the Republican Party also aim to render it ineffective.

Some consequences of the financial sector collapse of 2008 are clear. The European Economic Community appears instead of further integration, to be in danger of splitting as countries like Ireland, Greece, Spain and Portugal pile up huge global debts and need handouts, primarily from a well-run German economic administration. The UK and USA also have high deficits and debts that they must reduce. That will require moderation in government social benefits and in people's lifestyles in many rich countries as wages are kept controlled, benefits reduced, government expenditure reductions cause unemployment and poor economic growth. The nation that needs this discipline most of all is the USA. Efforts to curtail the deficit and the government debt are being made by both political parties. The curtailment will have maximum adverse impact on their lower income households while upper and high income households will most probably escape with little adverse impact. The Japanese economy has been in the doldrums for a decade, now shattered by the recent natural and man-made calamities. . Its recovery will require more deb. An aging population and a restrictive immigration policy make recovery problematic.

The USA is making efforts also to curtail its import of crude oil. The discovery and the investments in shale oil have promise of sharply reducing if not eliminating US imports of energy. This will add to energy costs, curb energy use and affect automobile production. The cuts in social welfare expenditures assure that incomes in the USA will grow more slowly and hence consumption and imports may not grow as fast.

The breakdown of regimes in Egypt, Tunisia, Yemen, Libya, Syria, and other Middle Eastern countries has already put pressure on crude prices that have reached record levels. This is a further pressure on world commodity inflation. World commodity prices have risen sharply (by 42% and food items by 47%. The American subsidies for ethanol have led to land being diverted to corn from soya and wheat, whose supplies have relatively fallen from the USA. Crop failures in China or India and increase in their imports will make their imports costlier.

China's worries about inflation have made it reduce its stimulus spending and the expectation that China will focus more on domestic consumption growth and production than on exports. The agreement among Brazil, Russia, India and China to use their own currencies instead of the dollar in their trade interchanges, will lead in the long run to a diminution in the role of the dollar as a global reserve currency.

This brief survey suggests that the global economy will slow down because of the developed countries and the tightening of their economic belts. Global warming and high energy prices will add to the pressure to reduce energy consumption and of products that use high energy like in transportation. Life style changes in the developed world are inevitable especially after the Fukushima nuclear disaster in Japan. This reduces the alternatives to coal. More expensive shale oil, solar and wind, along with gas, are likely to take much of the role of coal. Energy prices will be the key to higher costs and consequent life style changes.

India is in a more vulnerable position. Coal reserves are running out and Indian enterprises have not been able to buy up all the capacities they need to meet electricity needs in future years. More efficient coal use and carbon sequestration technologies will add further to energy costs along with the higher costs of coal. Imported crude and LNG will be expensive. Nuclear will no longer be an important answer to India's energy needs. Solar and wind will be expensive and in any case will meet only a fraction of the country's requirements. Food production also does not show the required growth.

India has no choice but to improve its economic management. Wasteful government expenditures must become more efficient. Government deficits must be converted to balanced budgets. Subsidies must be carefully targeted so that only the deserving beneficiaries receive them and they do not get stolen. Energy prices must reflect their cost, not be sold below cost as it is today. This will require a major political change as irresponsible political leaders give it free or below cost to consumers. Distributed power needs to be encouraged, and managed by local authorities.

Inflation control must be a top priority. For this, not only must government expenditures be controlled s that budget deficits are reduced if not eliminated but food production must get top priority. Emphasis must be on finding employment in rural India in medium and small industries. India must also encourage manufacture of efficient agricultural pump sets and energy efficient power equipment.

Our priorities must change if we are not to face a difficult future. Economic growth cannot be the primary priority; inflation control and protecting the really poor must be a major priority along with more efficient administration so that social benefits reach those they must and are not stolen. Administrative reform is urgent and must bring emphasis on accountability and efficient implementation.