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Faltering in a stormy sea of debt

By Martin Wolf
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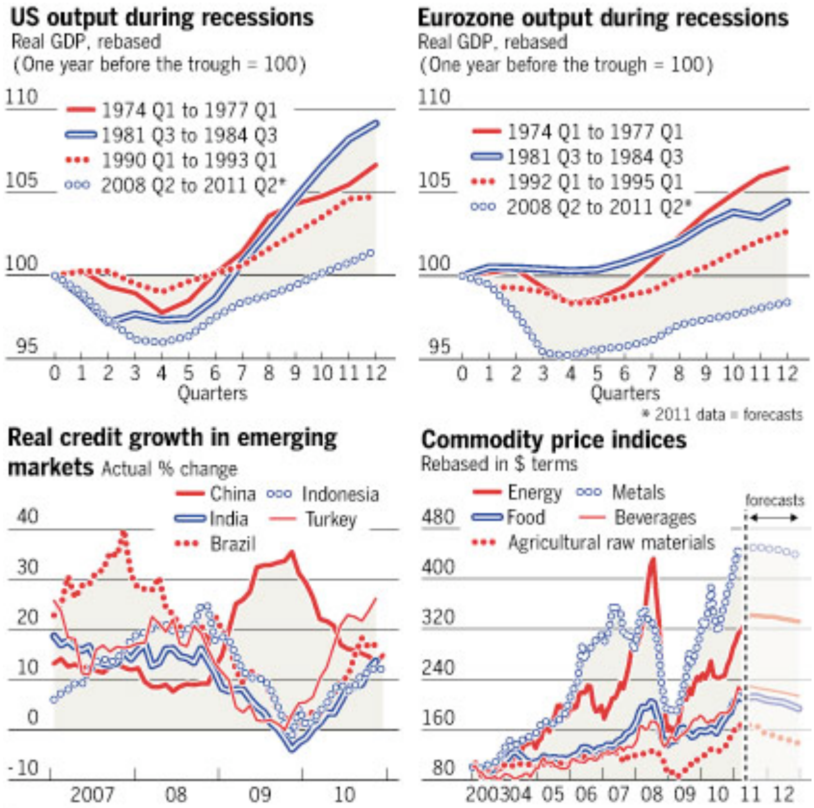
It is astonishing that **Standard & Poor's can say anything about the best-known debt class** in the world that is deemed to add value. This business is, after all, one of a class whose failures contributed mightily to the financial crisis. Nevertheless, the announcement that it was shifting its long-term rating on US federal debt from stable to negative reminded us all of something vital: the world economy is not on a stable path. On the contrary, to adopt a phrase often applied by the Chinese premier Wen Jiabao to his country, the world economy is "unsteady, unbalanced, unco-ordinated and unsustainable". The US fiscal position is just one of a number of risks – and far from the biggest.

This may not seem so clear from the forecasts in the latest **World Economic Outlook** of the International Monetary Fund. At the global level its forecasts are the same as in January: a healthy 4.4 per cent growth in 2011 and 4.5 per cent in 2012. Even at market exchange rates, growth is forecast at 3.5 per cent and 3.7 per cent, respectively. The volume of world trade is forecast to expand 7.4 per cent this year and 6.9 per cent in 2012, after the post-crisis recovery of 12.4 per cent in 2010. Inflation, too, is forecast to be reasonably under control, with consumer prices rising 2.2 per cent in 2011 and 1.7 per cent in 2012 in advanced economies. Even in emerging countries, inflation is forecast to fall from 6.9 per cent this year to 5.3 per cent in 2012.

The WEO also lays out the pattern of divergent growth. Advanced countries are forecast to experience a moderate recovery, with growth of 2.4 per cent in 2011 and 2.6 per cent in 2012. Meanwhile, emerging and developing economies are forecast to expand 6.5 per cent in both years, with developing Asia, led yet again by China and India, forecast to grow 8.4 per cent in both years.

This is a world-transforming. But it is also a time of great uncertainty. The IMF's **Global Financial Stability Report** opens with the bold view that "risks to global financial stability have declined" since October 2010. Confidence has indeed improved. But reality is quite another matter.

First, the advanced countries are in no sense back to normality: fiscal deficits remain exceptional; monetary policy is hugely accommodative; the financial sector is fragile, particularly in the eurozone; credit growth has been remarkably slow in the US and eurozone; households of several countries, including the US and UK, remain highly indebted; and there exists the possibility of sovereign defaults, bank failures or both within the eurozone. Moreover, despite the scale of the monetary and fiscal stimuli applied, the recovery in these countries is still expected to be anaemic (see chart).



Source: IMF

Second, while advanced countries are in the doldrums, several emerging economies are suffering from excessive credit expansion and overheating. In many countries, particularly in developing Asia and Latin America, output is well above the pre-crisis trends. Particularly disturbing are the positions of Argentina, Brazil, India and Indonesia. “In many of these economies,” notes the IMF, “both headline and core inflation either are rising from low levels or are fairly high already.” The IMF picks out Brazil, Colombia, India, Indonesia and Turkey; over the past five years, credit per head has almost doubled in these economies, in real terms. Much of this flows into real estate. The IMF adds that “such expansions are close to those experienced before previous credit booms and busts”.

Third, complex and disturbing interactions occur between the two sides of our divided world economy.

One of these comes via the emergence of a commodity price boom (see chart). The IMF commodity price index rose 32 per cent between June 2010 and February 2011. Behind this surge lies strong demand in fast-growing emerging economies, particularly China, adverse supply conditions, particularly for food, and political instability in certain oil-producing countries. Some argue that monetary policy is responsible. This is unpersuasive. But ultra-low interest rates lower the cost of financing inventories, while the decline in the US dollar raises the dollar prices.

Rapidly rising commodity prices help cause high inflation in emerging economies and stagflation in advanced countries. The result is pressure for monetary tightening. A global central bank might be tightening monetary policy sharply, even though such a response to a shift in relative prices would compel other prices, including wages, to fall in nominal terms. Certainly, rising commodity prices create challenges for monetary policy everywhere.

Another interaction comes via capital inflows and consequent upward pressure on exchange-rates in emerging countries. Monetary tightening exacerbates the pressure. But exchange rate pressure does not fall evenly, since China manages its exchange rate so effectively. Many countries are concerned that allowing appreciation and large current account deficits makes their economies vulnerable to shifts in US monetary policy. The IMF suggests that “capital controls may be the only instrument available to the authorities in the short term”. But whether open economies can wield them as well as China is doubtful.

Last, but not least, we have the related issue of rebalancing of global demand. Despite overheating in a number of emerging countries, the IMF concludes that rebalancing has stalled. As it also notes, the adverse demand consequences of fiscal rebalancing in the high-income countries need to be partly offset by rising net exports. Unfortunately, it notes, “a disproportionate burden of demand rebalancing since the beginning of the crisis has been borne by economies that do not have large current account surpluses but attract flows because of the openness and depth of their capital markets”. Such rebalancing – both limited and malign – greatly increases the risks of more financial shocks.

In all, policymakers confront a host of complex and interlocking challenges: fiscal and monetary normalisation in advanced countries; fixing the overhang of excess debt and financial fragility in those economies; managing the overheating in emerging economies; adjusting to big shifts in relative prices; and rebalancing the entire pattern of global demand. Nothing that is now happening suggests any of this will be managed competently, let alone smoothly. In short, those who think we are now looking at the sunlit uplands are fooling themselves. Much disruption lies ahead.

martin.wolf@ft.com