FT.com FINANCIAL TIMES

MARKETS
ASK THE EXPERT

Close

US slowdown goes global

Print

Published: June 25 2008 14:23 | Last updated: June 30 2008 14:36

Just when many emerging market companies were starting to flex their muscles in the global marketplace, the major economies suffered in the wake of the US subprime crisis and the credit crunch that followed.

How damaging has the economic slowdown in the US, Europe and developed Asia been on the emerging economies? What pressures have spiralling inflation through high commodity prices put on global markets?

Mauro Guillén is Director of the Lauder Institute and professor of international management at the Wharton School of the University of Pennsylvania. His answers to readers' questions are appearing below.

How successfully, do you think, have Asian emerging economies decoupled themselves from the struggling Western markets? Will rising domestic demand save them?
Sohaib Naim, Karachi, Pakistan

Professor Mauro Guillén: Emerging economies have historically been at the mercy of developments in the richer parts of the world.

Over the last two decades, however, their economic performance has become increasingly "decoupled" from Europe and North America. This may appear to be paradoxical because the globalization of markets for goods, services and money was expected to bring about more convergence and coordination, not less. Can globalization and decoupling both be taking place at the same time? The answer is a resounding "yes."

Emerging economies have become less dependent on rich markets for three reasons:

First, as you point out, they have developed more of a domestic market, not just for consumer goods but also for investment in equipment and in infrastructure (which is not always tied to exports). If consumer and business confidence does not fizzle, growth in emerging economies is likely to continue its upward trend.

A second way in which decoupling has taken place is due to changing patterns of trade. Emerging economies are increasingly trading with each other, thus buffering themselves from the present downturn in the United States and most European countries.

Although China is hugely dependent on the U.S. market, it is less so today than a decade ago. Chinese exports to the other three Bric countries, for instance, have surged by more than 50 per cent from last year, and it is also selling ever larger quantities of goods to the oil-rich Middle East. South Korea and Taiwan have also benefited from the development of other emerging economies, which has enabled them to diversify away from the U.S. market.

A third important factor is that prices for raw materials and energy are not likely to fall as a result of the downturn. This is due to surging demand from China, India, and the fast-growing Latin

American economies. Thus, emerging economies that are big producers of commodities will not be hurt by the downturn in the U.S. and Europe, at least not as much as in the past.

In summary, emerging economies are likely to continue growing even as the rich part of the world slumps. Keep an eye on inflation, though. It could spoil the party.

--**Would you be able to provide an outlook for commodity prices and the Brazilian economy in particular?**
Miguel Castellanos, Ft. Lauderdale, FL

MG: I do not see a fall in commodity prices any time soon. There are two key developments to watch:

The first is to wait and see how deep and long the economic downturn in the U.S. and Europe will be. If it proves shallow and brief, as a growing cadre of economists are predicting, then commodity prices will remain at record levels.

A second issue to keep in mind is demand from emerging economies with a rapidly expanding domestic consumption and capital spending.

The latter is growing swiftly in China, India, Brazil and elsewhere, and it is not always linked to exports. Infrastructure spending, in particular, will continue to grow at double-digit rates in many emerging economies, fuelling demand for all sorts of raw materials.

Energy prices are also likely to continue growing as demand in emerging economies expands, supply bottlenecks go unresolved, and political uncertainty remains high in certain oil-producing countries.

Brazil is the country of the future, and this time around it could well realize that potential. Its macroeconomic outlook is strong. Demand for Brazilian manufactures as well as raw materials is likely to continue growing in the medium run.

Another promising development has to do with the recent oil finding off-shore. I am personally very optimistic. Brazil is a major exporter of commodities, but the largest category is actually transportation equipment and parts (about 12 percent of the total). GDP growth is robust, and inflation low.

Now Americans can't afford to buy made-in China-deer hunting hides that hang in trees and other rubbish to clog up their garages, how much will this affect Chinese and other Asian exporters?
David Lyttle, New Zealand

MG: I agree that Americans have spent way too much on consumer durables and non-durables they really did not need. What's worse, most have borrowed in a variety of ways in order to indulge in such short-sighted behaviour.

The decline of the dollar, though in part driven by the yawning gap in monetary policy across the Atlantic, is mostly a reflection of the ballooning fiscal and trade deficits, and the low savings rate.

Asian exporters will be affected by these developments, but one should keep in mind that, as their domestic consumer markets grow, they are increasingly selling to each other as opposed to the United States.

Having said that, a long and deep downturn in Europe and the U.S. would hurt them, but not as much as, say, 5 or 10 years ago.

What will be the real impact of the slowdown on Third World countries?
Jimmy, New York

MG: I do not believe Third World, i.e. truly poor, countries are being hurt by the slowdown in the

U.S. and Europe. As long as emerging economies continue growing, demand for energy and raw materials will remain solid.

I see the problem in a different area, namely, food prices. Increased demand from the rapidly-growing emerging economies and wrong-headed biofuel policies have caused a quintupling in the price of some staples such as wheat, corn and beef. This, and not the slowdown, is devastating some of the poorest countries in the world.

How will China retain their subsidies in the wake of a decreasing trade surplus? Will the Chinese resort to deficit spending?
Phil Vernes, CT

MG: I am deeply concerned about gasoline subsidies in China, which run at billions of dollars a year. It is simply foolish for them to continue this charade. The longer it goes on, the harder it will be for people to adjust to the harsh reality of high energy prices. I sincerely hope that they will gradually eliminate the subsidies. This is a no-brainer.

What is your feeling about the effects of recent crises on Russia, as a major producer of energy products? Would it be easier to cope with inflation inside of the country, who owns natural energy sources?
Vlad Kamlyuk, Ireland

MG: Russia is enjoying a boom in commodity and energy markets. Prices are likely to remain high for the foreseeable future, so there will be little incentive for the country to change direction.

I say this because the downturn in the U.S. and Europe is unlikely to reduce global demand by much, as emerging economies are still growing and “decoupling” has taken hold. Inflation is indeed a problem, but definitely not the most important one in the long run. Russia is running the risk of becoming too specialized in raw materials and energy (already about 80 percent of total exports).

Russian manufacturing was not in good shape to begin with, and the last few years have been devastating. Many of the country’s most talented scientists and engineers migrated during the 1990s

Wage inflation makes it difficult for firms to compete internationally. The service sector is run by state bureaucrats, and there are alarming signs of lack of transparency, even corruption. While increasingly wealthy, Russia could and should avoid wasting its human capital and its many other resources.

How, in your opinion, would high commodity prices affect the economic recovery of Central and Eastern European nations and, in particular, the Baltic states?
Maksim Greinoman, Tallinn, Estonia

MG: High commodity prices are generally detrimental to Estonia, Latvia and Lithuania because of their dependence on imports, their large trade deficits, and the inflationary pressures (which have thwarted their entry into Europe´s monetary union). They do benefit from price increases to the extent they export raw materials such as timber, but on the whole they are mostly hurt by it.

The three Baltic states have grown very rapidly over the last few years thanks to a construction boom and to privatization. But the competitiveness of the manufacturing sector has been undermined by rising wages. The three countries need to increase productivity if they are to succeed in a fully integrated Europe.

Do you think the Sarbannes-Oxley legislation in the US and other such accounting procedures forcing companies to write down losses are more responsible for current problems than anything else? If that is the case, shouldn’t there be efforts to introduce a better system?
Nitesh Bansal, India

MG: Sarbannes-Oxley has been (justifiably) blamed for inducing a number of problems, including the loss of global competitiveness of U.S. financial markets and of corporate America in general.

Writing down losses in asset values, however, is a reasonable and highly desirable accounting practice prevalent around the world, which predates recent regulatory changes.

Investors expect company accounts to reflect the present market value of their assets.

We are living through a crisis that is fundamentally one of declining confidence. If companies were able to carry assets on their balance sheets at the inflated values of the recent past, investor confidence would plummet. I would then fear a drastic drop in stock market turnover, further fuelling the liquidity problems afflicting the global economy since last summer.

Given the improvement in fiscal position of emerging market countries, their increasing important domestic demand and their infrastructure spending plans – do these elements combined justify a re-rating in the relative premium investors should seek vis-á-vis developed markets? Should emerging market equities demand a premium to developed market equities in the coming years?
Jim Sheffield, Charlottesville, VA

MG: International investors demand a premium if they believe that there are unusual risks. Improvements in fiscal position, trade surpluses, inflation, and robust domestic demand may or may not reduce the risks. While many emerging economies are now enjoying fiscal and trade surpluses, inflation is picking up speed.

Inflation can worsen trade balances and the exchange rate, thus generating risk to the international investor. Some analysts argue that fiscal surpluses, while a sign of discipline, may also increase the ability of the government to make the wrong decisions, thus generating uncertainty.

In the long run, I would focus the attention on the institutional structures of emerging economies, on the ability of governments to credibly commit to a set of policies in the long run, and on the functioning of the judiciary and the political system in general. I personally believe that there is plenty of "institutional" risk in emerging economies in spite of the relatively favorable macroeconomic outlook. As a result, I would continue to demand a premium.

Is the current stagflation (in the US and some EU members) here to stay, given the current level of global competition? Now that the Brics nations and major oil exporters are fast emerging, is the world geared up for dramatic changes in the activities of multilateral institutions in dealing with issues of global concern?
Augustin Dufatanye, Reykjavik

MG: We are all hoping that stagflation will not be here to stay. But the signals and the indicators are not too encouraging. The biggest threat is inflation in emerging economies, which could derail the only engines of growth that exist right now. In the U.S. and Europe, inflation must be kept in check.

Regarding multilateral institutions, there has been a flurry of activity redesigning their roles and the voting power of different countries. We are definitely at a crossroads, for two reasons.

One is the rise of the Brics, that is, their increasing weight in the global economy. The other is the trade imbalances resulting from the rise in commodity and energy prices. On the positive side, we are better equipped today to deal with these issues than 35 years ago. Economies and markets are much more flexible today. But people will need to absorb much of the shock in the form of unemployment, relocation, and the like.

It seems that the markets are being roiled in a battle between recession and inflation. The Fed Reserve has an ability to raise rates and possibly decrease the risk associated with inflation. What can we anticipate, should recession be the overriding factor in the US ,and what are the

long term effect on world markets? Should the US Congress intervene and attempt to control the price rise for oil as suggested?
Robert J. Arnell III, Hardwick, Vermont

MG: Policymakers are definitely in a bind.

An economic slowdown with inflation is not only difficult to deal with from an economic point of view; it is also an explosive combination politically. Some groups in society detest inflation, while others have a more tolerant attitude towards it.

In the U.S. I would not expect any bold action until after the November election.

There is still hope that the worst of the credit crunch is over, or nearly over, and that the slowdown will be shallow and brief. But we still do not have enough information to make that call.

Regarding the U.S. Congress, I very much doubt that they can affect oil prices in the short run. In the long run, legislation could encourage both conservation and supply expansion. I would hope the right incentives are introduced for a massive investment boom in alternative energy sources, especially hydrogen automobiles, wind, and solar.

Lastly, the present biofuel incentives need to be revisited, given their impact on agricultural markets

---

What is the engine for recovery in the United States if it is not housing, autos, capital spending and commercial construction? These are the typical interest rate sensitive areas that normally lead you out of a recession. Rates are actually higher than before the Fed started lowering rates for most of the above and these areas will remain weak through 2009 and some of them will be weakening through 2009-10.
Alex Sinclair, Rancho Mirage, Ca

MG: The U.S. economy's best chance for recovery lies in its flexibility, its ability to adapt to change. We have already seen a surge in exports in response to the weak dollar. Unfortunately, federal, state, and city governments are deeply in deficit, so they cannot help out by accelerating infrastructure spending and the like. Perhaps the most important "engine" is confidence.

Consumers and lenders need to regain their mutual confidence. This trust has been shattered over the last 12 months in the wake of the subprime crisis. The damage has not yet been contained, and it is spilling over into many different areas.

An economy so dependent on domestic consumption cannot possibly grow robustly if there is a lack of confidence among economic actors. The key is to a recovery lies in rebuilding the foundations of confidence. The Fed and the new president elected in November will have to work hard to put the pieces back together.

How can India maintain a 7 per cent to 8 per cent GDP growth over the next 15-20 years but keep inflation between 3 per cent and 4 per cen?
Aspi Contractor, USA

MG: As a net importer of commodities and energy, India is indeed prone to fierce inflationary pressures, and this could derail the very robust GDP growth that the country has been experiencing.

With elections coming soon, it is not clear that the government will do what would be best in the long run.

Prime Minister Singh might be tempted to strengthen the base of support for this party, but the public-sector deficit is already quite large.

The best recipe is to continue introducing reforms and deregulation, especially in the infrastructure and energy sectors of the economy. Policymakers need to signal very forcefully that they will not let inflationary expectations build up.

Taxes on investment and other burdens could be lessened so that both portfolio and direct investment flows into the country at increasing rates. India needs more foreign investment to fuel growth, especially in the service sector.

What's your view on the countries of the old Soviet Union? Some of them can hardly be called emerging markets.
Dilmurad, Nashville, Tn USA

MG: I am quite optimistic about the prospects for the former Soviet republics bordering on the European Union, assuming they work hard to create robust political and legal institutions over the next decade or so.

The central Asian republics are a different story. They do not have too many options. They are not natural manufacturing enclaves, given their geographical location. They are subject to strong geopolitical influences. Some of these countries have been growing very quickly.

The largest, Kazakhstan, continues to grow at 5 or 6 percent, but inflation, deficits, and the credit crunch could slow down the economy.

In the long run, the central Asian republics need to come up with some mutual understanding as to how to create a common market. It does not make sense for them to operate in isolation of each other.

The global credit crunch seems to have made Spain awaken to the risks of its economic imbalances. What is your perspective on Spain's ability to deal with the crisis? How do you see Spain in the future, more like Germany or Italy?
Carlos Colomer, Madrid, Spain

MG: Spain faces a difficult situation.

The signs of trouble were already visible a few years ago, but they were crowded out by the construction boom and the excellent performance of Spanish firms across the board.

The Spanish economy has long suffered from three interrelated problems: sluggish productivity growth, an inflation differential with the euro area, and meager expenditures on innovation and research and development. The credit crunch has added to the problems.

While Spanish banks are very solid (and did not participate in the subprime market), they are no longer lending money to each other, and they have tightened lending practices. Spanish firms are shielded from the slowdown because of their massive presence in Latin America. But the problems with productivity, inflation, and innovation remain.

Spain has recently overcome Italy in per capita income. This is in part due to Spain´s successes, and in part thanks to Italy´s many problems, especially with its politicians.

Spain has done well after privatising, deregulating, and opening the economy. But these reforms need to be further deepened. Spain lacks Germany´s discipline and innovativeness. Germany is an export machine; Spain runs the second largest trade deficit in the world after the US

The issue right now is whether Spain will avoid a prolonged slowdown or even recession or not. The next few months are crucial, especially in terms of job destruction.

Can it be said that the subprime crisis in its totality is a "zero-sum" game? If the banks have lost money some body has gained in the transactions, so the wealth in the economy as whole has not been destroyed, only it has been redistributed. So how this is creating slowdown in the economy as a whole?

Bikramjit Bhawal, Italy

MG: The subprime crisis has wreaked havoc on the balance sheets of major financial institutions in the U.S. and Europe. That in and of itself is a major problem that no other gains obtained by other economic actors can possibly compensate.

Financial stability is very important. It should also be remembered that the credit crunch is a crisis of confidence, and it will be very difficult to rebuild. There have been ”winners”, to be sure, including those who shorted financial stocks, the buyers of certain securities at bargain prices, and others.

But the pain being felt around the world is huge. Let us not forget that many people are losing their jobs, their homes, or both, as a result of this crisis. Plus consumption, a major driver of economic growth, is on the decline. Wealth has been wiped out in many different ways because the prices of many different kinds of assets have declined sharply. We are now paying for the excesses of the last few years, and for the lack of appropriate regulatory oversight

I wished the wins were big enough to offset the losses. Unfortunately, this is not a zero-sum situation.

The most thought-provoking online contributions may be published in the Financial Times newspaper, so please supply your full name and location.