

Stagflation cometh

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The world economy has had several good years. Global growth has been strong, and the divide between the developing and developed world has narrowed, with India and China leading the way, experiencing GDP growth of 11.1% and 9.7% in 2006 and 11.5% and 8.9% in 2007, respectively. Even Africa has been doing well, with growth in excess of 5% in 2006 and 2007.

But the good times may be ending. There have been worries for years about the global imbalances caused by America's huge overseas borrowing. America, in turn, said that the world should be thankful: by living beyond its means, it helped keep the global economy going, especially given high savings rates in Asia, which accumulated hundreds of billions of dollars in reserves. But it was always recognized that America's growth under President George W. Bush was not sustainable. Now the day of reckoning looms.

America's ill-conceived war in Iraq helped fuel a quadrupling of oil prices since 2003. In the 1970's, oil shocks led to inflation in some countries, and to recession elsewhere, as governments raised interest rates to combat rising prices. And some economies faced the worst of both worlds: stagflation.

Until now, three critical factors helped the world weather soaring oil prices. First, China, with its enormous productivity increases – based on resting on high levels of investment, including investments in education and technology – exported its deflation. Second, the United States took advantage of this by lowering interest rates to unprecedented levels, inducing a housing bubble, with mortgages available to anyone not on a life-support system. Finally, workers all over the world took it on the chin, accepting lower real wages and a smaller share of GDP.

That game is up. China is now facing inflationary pressures. What's more, if the US convinces China to let its currency appreciate, the cost of living in the US and elsewhere will rise. And, with the rise of biofuels, the food and energy markets have become integrated. Combined with increasing demand from those with higher incomes and lower supplies due to weather-related problems associated with climate change, this means high food prices – a lethal threat to developing countries.

Prospects for America's consumption binge continuing are also bleak. Even if the US Federal Reserve continues to lower interest rates, lenders will not rush to make more bad mortgages. With house prices declining, fewer Americans will be willing and able to continue their profligacy.

The Bush administration is hoping, somehow, to forestall a wave of foreclosures – thereby passing the economy's problems on to the next president, just as it is doing with the Iraq quagmire. Its chances of succeeding are slim. For America today, the real question is only whether there will be a short, sharp downturn, or a more prolonged, but shallower, slowdown.

Moreover, America has been exporting its problems abroad, not just by selling toxic mortgages and bad financial practices, but through the ever-weakening dollar, in part a result of flawed macro- and micro-policies. Europe, for instance, will find it increasingly difficult to export. And, in a world economy that had rested on the foundations of a “strong dollar,” the consequent financial market instability will be costly for all.

At the same time, there has been a massive global redistribution of income from oil importers to oil exporters – a disproportionate number of which are undemocratic states – and from workers everywhere to the very rich. It is not clear whether workers will continue to accept declines in their living standards in the name of an unbalanced globalization whose promises seem ever more elusive. In America, one can feel the backlash mounting.

For those who think that a well-managed globalization has the potential to benefit both developed and developing countries, and who believe in global social justice and the importance of democracy (and the vibrant middle class that supports it), all of this is bad news. Economic adjustments of this magnitude are always painful, but the economic pain is greater today because the winners are less prone to spend.

Indeed, the flip side of “a world awash with liquidity” is a world facing depressed aggregate demand. For the past seven years, America’s unbridled spending filled the gap. Now both US household and government spending is likely to be curbed, as both parties’ presidential candidates promise a return to fiscal responsibility. After seven years in which America has seen its national debt rise from \$5.6 trillion to \$9 trillion, this should be welcome news – but the timing couldn’t be worse.

There is one positive note in this dismal picture: the sources of global growth today are more diverse than they were a decade ago. The real engines of global growth in recent years have been developing countries.

Nevertheless, slower growth – or possibly a recession – in the world’s largest economy inevitably has global consequences. There will be a global slowdown. If monetary authorities respond appropriately to growing inflationary pressure – recognizing that much of it is imported, and not a result of excess domestic demand – we may be able to manage our way through it. But if they raise interest rates relentlessly to meet inflation targets, we should prepare for the worst: another episode of stagflation.

If central banks go down this path, they will no doubt eventually succeed in wringing inflation out of the system. But the cost – in lost jobs, lost wages, and lost homes – will be enormous.

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