

The world economy remains adrift in choppy waters

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The world economy is beset by a dangerous combination of divergent growth patterns, deficient demand, and deflationary risks. The latest update of the Brookings-Financial Times TIGER (Tracking Indexes for the Global Economic Recovery) reveals sharp divergences in growth prospects between the advanced economies and emerging markets, and within these groups as well.

Growth prospects for the advanced economies have improved, but this is largely on account of good growth in the US and the UK. The euro zone remains mired in low growth and Japan's economy appears to have stalled again. Commodity-exporting countries, both advanced and emerging, have been hit by sharp growth slowdowns.

The US economy continues to strengthen, with domestic demand picking up momentum, as reflected in rising retail sales and investment. Despite healthy employment growth and a falling unemployment rate, wage pressures remain muted. Inflation has stayed low, aided by a strong dollar and weak energy prices, and the CPI index has flirted on and off with deflation. Credit growth remains robust but US equity markets, industrial production, and exports have all been held back by economic weakness in the rest of the world. The strong possibility that the Federal Reserve will commence its rate hike cycle in December points to how asynchronous the US recovery is relative to business cycle conditions in most other advanced economies.

The euro zone and Japan face a difficult combination of weak growth, near-deflationary price changes, and the absence of fundamental reforms needed to revive domestic demand.

Overall growth index

Advanced economies are holding up better than emerging markets, which are in a slump



Source: Brookings Tiger Index

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Any growth at all in the euro zone is considered a victory and the zone has certainly kept to those expectations, growing at less than half a per cent in the second quarter. The Japanese economy contracted in the second quarter. Despite highly expansionary monetary policies, inflation in both economies is barely positive.

Emerging market economies, which had become the main drivers of global growth in the aftermath of the financial crisis, are now leading the world economy into a slump. Growth has fallen, business and consumer confidence are eroding, and financial markets have taken a beating in these economies.

Confidence index

Business and consumer confidence have fallen sharply in emerging markets



Source: Brookings Tiger Index

Most economic indicators point to a loss of growth momentum in China, with high-frequency indicators such as electricity consumption and freight volumes pointing to an even sharper manufacturing slowdown. While policymakers still have some room to boost growth closer to the 7 per cent target, the inability of monetary policy measures to gain traction in raising growth has elevated risks to the financial system and shaken confidence in the economic management skills of the

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leadership. These concerns have been

exacerbated by recent missteps in managing stock market volatility and the shift to a more market-determined exchange rate, both of which have been marred by an unclear strategy and weak communication.

Among the major emerging markets, India alone continues to maintain strong GDP growth, although industrial production and other indicators of economic activity suggest that the economy is in less robust shape.

Disinflationary pressures remain a feature of many emerging markets as well. In China, CPI inflation is around 2 per cent but PPI deflation has intensified to nearly 6 per cent. In India, CPI inflation has fallen below 4 per cent, a sharp fall from about 10 per cent just a couple of years ago, while WPI inflation has turned negative.

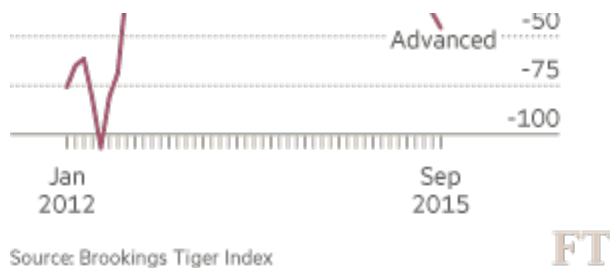
There is a different set of emerging markets experiencing a complex set of problems—stalled growth, high inflation, and falling currencies—stemming from macroeconomic mismanagement and political instability. Brazil's economy is shrinking, inflation is close

Financial index

Equity markets have fallen worldwide as investors cope with multiple sources of uncertainty



to 10 per cent, and the Brazilian real's value has fallen by more than 30 per cent against the dollar this year. Countries such as Russia, South Africa, and Turkey have all taken sharp hits to growth and currency values, often in tandem with high inflation.



Monetary policy remains the go-to policy tool in most countries, with cheap money and weak currencies becoming the main hallmarks of ostensibly aggressive countercyclical policies. However, the impotence of monetary policy in boosting growth and staving off deflationary pressures has become painfully apparent, especially when it is acting in isolation and when a large number of countries are resorting to the same limited playbook.

The policy prescriptions for most economies remain much the same as in years past—a more balanced set of macroeconomic policies, accompanied by deep-rooted structural reforms. But few lessons seem to have been learnt and absorbed by national leaders, who continue to rely largely on the convenient but wobbly crutch of monetary policy.

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