Global Power Shift

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As we enter a new decade, there are a number of uncertainties about the current status and long term prospects of the global economy. The International Monetary Fund (IMF) estimates that the rate of growth in Europe has been sluggish and the outlook for the world's largest economy, the US, remains uncertain. The current and future state of the global economy is largely attributed to the credit crisis that ensued following the sub-prime mortgage debacle in the US. The toxic credit crisis then spread across the Atlantic and now threatens the future of the Euro. Europe, Greece and Ireland are being helped through financial packages and there is concern that the market pressure may also create a liquidity crisis for Portugal and Spain. However, one must question whether it is right to treat the financial crisis which has affected the major developed western economies as a 'global crisis'.

Although the financial markets in the emerging economies of China and India did react to the adverse developments in the US and Europe, these reactions were short-lived. Both economies continue to grow at their long term growth projections.

It is estimated that whilst China's GDP will continue to grow by around 9%, India will not be far behind with around 7.5% annual rate of growth for the foreseeable future. In a recent study, PricewaterhouseCoopers suggests that the global financial crisis has accelerated the shift in economic power from the developed to the developing economies. If they continue to grow, the economic output of the emerging markets of China, India, Brazil, Russia, Mexico, Indonesia and Turkey, the so-called E7, would overtake that of the established G7 nations: US, Japan, Germany, UK, France, Italy and Canada by 2032.

These developments have major implications for developed economies like the UK. It is estimated that the UK exports around 7% of its total exports to developing economies. As the economic power shifts to the emerging economies, unless the UK increases its share of exports to developing countries it will miss the opportunity to be part of the growth. On the other hand there are serious challenges for the government and policy makers in emerging economies. The higher rates of growth coupled with higher rates of interest in emerging economies, are already attracting hot capital flows. This is putting upward pressure on their currencies. Over the last two years or so, most of the currencies of developing countries have increased in value significantly against the US dollar. Brazil provides a good case, where the Brazilian Real has risen by nearly 40% against the US dollar prompting the government to actively intervene in the currency markets.

The Brazilian banks have been directed to hold higher reserves against their foreign exchange positions and the tax rate on income earned by foreign investors from Real denominated bonds has been doubled to 4%. Excessive liquidity created by quantitative easing pursued by developed economies including the US and the UK has led to spiralling commodity prices. Inflation rates in emerging economies have increased and a steep increase in food prices is posing a serious threat to policy challenges and economic gains.

The financial crisis has exposed the hazards of excessive dependence on debt. The credit crisis has provided significant insights into the short-sighted business practices of the financial services industry in general and the banking sector in particular. Banks which generously offered credit to financial markets and the corporate sector, have now become highly risk averse. Furthermore, the emerging economies of India and China require huge investments in water systems, transport, infrastructure, housing and power generation. These economies do not have high levels of capital accumulation and therefore to finance the growth, capital from other parts of the world must flow to emerging economies. These developments bring significant implications for businesses in the developed economies. First and foremost, availability of capital in developed economies will be scarcer as it will be directed to the growing emerging economies. Consequently, less supply of capital will lead to higher costs and access to credit will be increasingly challenging. Secondly, high saving developing economies have been an important source of capital for the developed world for many decades. However as these economies grow and the standard of living improves, consumption levels in these countries will rise, causing a decline in savings. This is likely to cause further reduction in the availability of capital. Finally, higher financing costs will reduce stock market valuations thereby adversely affecting stock market performance. These developments will create serious managerial challenges in the developed world. Businesses will have to become smarter and more innovative. The likely shortages in availability of capital would mean that managers will have to invest scarce capital a lot more judiciously. Good banking relationships will be a critical success factor for gaining competitive advantage as access to finance will become increasingly difficult. Technological innovations which have provided competitive advantage in the past will be another key factor to remaining competitive in the wake of increased competition from the emerging economies. MF

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