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The Outlook for the Global Economy in 2005: Dealing with an Unbalanced World

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The outlook for the global economy in 2005:
Dealing with an unbalanced world.[1]

Mark P. Thirlwell

Introduction: Stress testing the consensus

Below I sketch out what I think is a reasonable base case scenario for growth next year – an assessment that is intended to be a reasonable thumbnail of the current consensus – and then stress tests four of the key assumptions on this consensus scenario rests. These four issues are all centred about a common organising principle: the need for the world economy to manage the adjustment processes related to some significant economic imbalances.

Review and outlook: strong growth in 2004, moderating in 2005

A reasonable baseline forecast for next year is for a moderate decline in the pace of world economic growth, as the international economy downshifts to something closer to trend.

In 2004 the world economy has been running on steroids – fiscal and monetary ones, supplied mainly by a US economy that has perhaps become hooked on policy stimulus – and one consequence has been that the world has probably turned in its strongest growth performance in almost three decades. According to the IMF for example, world output is likely to have grown at about 5% this year, well in excess of the 4% historical trend rate, and the fastest pace of global expansion since 1976.[2] Global growth has been powered by economic recovery in the US,[3] some pickup in Japanese activity[4], and extremely rapid growth in China. These developments have in turn contributed towards, and been supported by, a good year for world trade, with volumes up by more than 10% and China accounting for more than 20% of the gain.[5]

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[1] This *Perspectives* was originally presented as a Lowy Institute seminar on the outlook for the global economy on 1 December 2004.
[2] This figure is based on purchasing power parity (PPP) weights for world output, which give a higher weight to faster growing emerging markets such as China and India. Using market exchange rates the IMF thinks growth in 2004 will have been 4.1% or the fastest rate since 1988. International Monetary Fund, *World Economic Outlook September 2004.* Washington DC, IMF, 2004.
[3] According to the Commerce Bureau, US GDP growth picked up to a 3.9% annualised rate in the third quarter, rebounding from 3.3% in Q2.
[4] Although recent data point to a loss of momentum: GDP growth slipped to an annualised rate of 1.7% in Q2 this year, down from more than 6% in Q1.
[5] World Bank, *Global Economic Prospects 2005.* Washington DC, World Bank, 2004.

Several factors are likely to lead to some moderation in the pace of global activity in the coming year. These include:

- The continued withdrawal of fiscal, and especially monetary, stimulus, particularly in the US;

- A slowdown in China in response to a series of moves to tighten policy;

- And the dampening effect of higher commodity prices, especially oil prices, on global demand.[6]

As a result, growth in 2005 is likely to move back down to something closer to trend; the IMF for example thinks that world GDP will grow by 4.3% next year.

Four key assumptions

I think that this outline broadly captures something resembling the consensus projection for the next twelve months. Such a forecast obviously rests on a whole host of assumptions, but here I want to focus on just four, all of which can be linked to the general theme of the need for the world economy to adjust to a series of economic imbalances.

- The first and probably the most important assumption is that the world economy will see an orderly adjustment to a record US current account deficit.

- The second is that the continuing adjustment to tighter monetary conditions will be similarly smooth.

- Third, policymakers in Beijing are successful in achieving a 'soft landing' for the runaway locomotive that is the Chinese economy.

- Fourth, and finally, that this year's run-up in world oil prices is not sustained at current levels through 2005.

[6] According to estimates produced by the IEA, OECD and IMF earlier this year, a sustained US$10 / barrel rise in the oil price would slice off half of one percentage point from world GDP growth in the following year. The current price spike has been on the order of US$20-25 / barrel and therefore could indicate a full percentage point hit to global growth. International Energy Agency, *Analysis of the impact of high oil prices on the global economy.* Paris, IEA, 2004.

Let's think about each of these assumptions in turn.

1. Can we bank on an orderly adjustment to US external imbalances?

The US current account deficit is currently at record highs, running at well over US$600 billion on an annualised basis, or equivalent to some 5.7% of GDP, and requiring more than US$2½ billion of external financing every working day.[7]

It seems to me therefore that a key assumption behind the forecast of a relatively gentle slowdown in the global economy next year is that there is also a fairly measured adjustment to this deficit, with an orderly depreciation of the greenback and a global and sectoral *redistribution* of economic growth, rather than a sharp contraction in activity and a plunge in the value of the dollar. Indeed, some might even argue that no correction is necessary at all, that the world can go on much as it is, pointing to the stability conferred by a 'Bretton Woods 2 system' or 'co-dependency' between Asia and the US.[8] (Although in recent weeks the belief in this line of argument seems to me to have started to waver.)

In terms of stress testing this particular assumption, I want to focus on the future path of the dollar, and suggest that there are a couple of good reasons to at least question the prospect of orderly adjustment.[9]

First, the debate over how the (nominal) exchange rate adjustment to a falling US dollar will be distributed internationally is yet to be settled; there still remains plenty of scope for disagreements between Washington, Brussels, Tokyo and Beijing. There is a series of potential fault lines here, with euro-area denizens worried that their already weak growth prospects are being dented by the euro taking an 'unfair' share of the currency appreciation burden, while the Japanese are concerned that a stronger yen would undermine their anti-

[7] A series of economic studies have found that a current account deficit in excess of 5% of GDP is associated with pressures for reversal. See for example Caroline Freund, *Current account adjustment in industrialized countries*. International Finance Discussion paper Number 692. Washington DC, Board of Governors of the Federal Reserve System, 2000. Also Catherine L Mann, Perspectives on the US current account deficit and sustainability. *Journal of Economic Perspectives* 16 (3) 2002.

[8] See for example Michael P Dooley, David Folkerts-Landau and Peter Garber, *An essay on the revived Bretton Woods system*. NBER Working Paper September 2003. Cambridge MA, National Bureau of Economic Research, 2003.

[9] The focus on the future path of the US dollar here reflects the content of the current debate and in particular the recent attention on foreign exchange markets and the sliding greenback. In fact there is a strong case to be made that the real story regarding international current account imbalances is not exchange rate misalignments but rather the growth in savings-investment imbalances in the US (reflecting large fiscal deficits) and in East Asia (reflecting the decline of private sector investment – outside of China – in the aftermath of the 1997 financial crisis). For a discussion of these issues see Jong-Wha Lee, Warwick J McKibbin and Yung Chul Park, *Transpacific trade imbalances: causes and cures*. Issues Brief September 2004. Sydney, Lowy Institute for International Policy, 2004. Available from the Institute's web site, www.lowyinstitute.org

deflation efforts. Similarly, much as the US economy has to yet to demonstrate that it can successfully wean itself from its addiction to easy money and debt-fuelled consumer-led growth, so many of the economies of East Asia have yet to fully accept the case for currency appreciation and at least some move away from their current export-led growth model. However, given that the unpleasant alternative in my view is likely to be a sharp upsurge in trade protectionism, some acquiescence to exchange rate moves on the part of the region, including by China, now seems increasingly likely. It also seems to me that a reasonable *quid pro quo* for participating in this international burden sharing would be a greater voice for the region in the bodies that try to coordinate international economic policymaking.

Second, however, even if exchange rate adjustment is distributed more evenly across the international economy, there is no guarantee that the process will be an orderly one. Indeed, a look at the history of exchange rate adjustments might lead one to think that overshooting is actually the *more* likely scenario.[10] If that proves to be the case, the interesting question then becomes how does this more dramatic currency adjustment play out?

One possibility is that we get a re-run of the 1980s. The parallels are obvious: a Republican president, twin deficits, and trade tensions with a major Asian economic power. A dollar 'crash' back then had a fairly benign outcome: despite a 30-40% fall in the trade-weighted value of the greenback, the hit to the US and to the world economy was relatively modest (although some would argue that the sharp yen appreciation at this time contributed to Japan's subsequent economic malaise).

Another possibility is much less comforting, however. Some observers have noticed that there are *also* strong parallels between the current situation of the US economy and the one prevailing in the early 1970s: budget and current account deficits, accommodative monetary policy, open-ended security commitments (with Vietnam filling in for Iraq and Homeland Security), and rising energy prices.[11] Needless to say, some form of re-run of the 1970s experience would imply a much grimmer outlook for the world economy than the one currently anticipated.

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[10] A separate reason for believing that the nominal exchange rate adjustment might turn out to be larger than currently expected is that the level of underlying *real* exchange rate adjustment delivered to date has been fairly modest when compared to that experienced in the 1980s, for example. Thus between March 1985 and May 1988 the real exchange rate (broad measure) depreciated by about 30%; between April 2002 and November 2004 it fell 15%.

[11] Maurice Obstfeld and Kenneth Rogoff, *The unsustainable US current account position revisited.* NBER Working Paper 10869 October 2004. Cambridge MA, National Bureau of Economic Research, 2004.

2. How will the adjustment to tighter monetary policy play out?

The second assumption that lies behind the consensus outlook is that adjustment to a tighter monetary policy stance, particularly on the part of the US Fed, will also prove to be orderly.

The likelihood of higher policy interest rates in the US is well known: the Fed has gradually been returning its policy settings to neutral since June this year, when it delivered the first of four 25bp rate hikes to date (June's was the first US rate hike since May 2000). But at its current level of 2% the Fed funds rate is still located firmly in expansionary territory, given that most estimates of the 'neutral' policy rate range between 3% and 5%, so most agree that further rate hikes are on the cards. The key question then is how the economy and financial markets respond.

The optimistic take is that, since the Fed has been quite transparent in signalling the case for policy tightening, higher rates should certainly come as no surprise, and markets, businesses and consumers should be well prepared. But pessimists worry that the preceding elongated period of 'super-loose' monetary policy has led US consumers to take on too much debt, has encouraged a surfeit of investment in interest-sensitive areas of the economy such as real estate, and has led to an excessive compression of financial market spreads in relation to relative risk. All of these are areas of potential vulnerability as rates rise. In other words, the withdrawal pains as the US economy comes down from its latest cheap money high could yet prove to be greater than expected.

Moreover, there is also the closely related risk that interest rates increase by more and more quickly than is currently anticipated, as they did in the global bond market rout of 1994.[12] Here there is a clear link to the previous discussion about the resolution of the US external imbalance, since, for example, a sharper than anticipated fall in the greenback would lead to higher interest rates as foreign investors in the US sought greater compensation for enhanced currency risk, and as the Fed factored in the possibility of a spike in inflation.[13]

[12] See Box 2.1 *The shift to tightening: parallels between 1994 and 2004* in International Monetary Fund, *Global Financial Stability Report April 2004.* Washington DC, IMF, 2004.

[13] Higher US rates would also have implications for financial stability in other economies. Heavily indebted emerging markets – the usual suspects include Brazil, Turkey and the Philippines – would be one set of victims, for example. See the discussion in World Bank, *Global Economic Prospects 2005*.

3. Can China achieve a 'soft landing'?

A third candidate for a stress test is the assumption that policymakers in Beijing will be successful in engineering a 'soft landing' for the Chinese economy.[14] (Incidentally, by a soft landing I mean a reduction in overall GDP growth from its current 9-10% rate to a growth rate of around 7-8 %.) Worried by overheating in key sectors such as steel, aluminium, cement and real estate, the authorities have relied on a mixture of command-economy style measures such as direct credit controls on banks along with a more recent shift to market-based instruments in an attempt to cool the economy.[15] A key question for the global outlook is whether the conclusion of the current growth cycle turns out to be more like its 1991-97 predecessor that ended with a fairly modest slowdown in growth, or the two earlier 1980s cycles which saw much sharper slowdowns.[16]

One issue to consider here is that the effectiveness of the policy measures taken to date has been mixed; headline annual GDP growth rates have slowed modestly, money and credit growth has fallen more sharply, and imports are down. But private consumption growth has stayed strong, as has industrial production, and investment also continues to expand rapidly, if at a slower clip. There is therefore some possibility that the authorities will be compelled to pursue further tightening measures, with the risk of overkill.

More generally, China looks to be in the midst of an unsustainable investment boom, with the share of investment in GDP having risen to more than 40% last year, and with spending on fixed investment growing at 28% over the period January-September this year (implying an investment share of at least 45% of GDP by year end). There seems to be a fairly significant risk that unwinding this boom could see a sustained slowdown in Chinese growth. [17]

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[14] After growing by 9.3% in 2003, China's GDP grew by 9.8% on a year ago in the first quarter of this year, by 9.6% in the second and by 9.1% in the third.

[15] On 29 October China increased its benchmark one-year lending rate for the first time in nine years. Interestingly, the same week saw India deliver an interest rate rise of its own, providing some empirical support for the case that the normalisation of interest rates is an international phenomenon.

[16] See Box 1.2 *What are the risks of slower growth in China?* In International Monetary Fund, *World Economic Outlook September 2004*.

[17] This is part of the argument advanced in Morris Goldstein and Nicholas R Lardy, *What kind of landing for the Chinese economy?* Policy Briefs in International Economics November 2004. Washington DC, Institute for International Economics, 2004.

4. How far will world oil prices fall?

The final assumption behind the baseline scenario I sketched out at the start is that world oil prices will decline somewhat from the high (nominal) levels recorded this year, rather than continue to stay stubbornly near their current US$45/barrel mark.

How likely are we to see a fall in prices? To some extent, the answer to this question depends on what has been behind the run-up in prices this year. A big part of the story has been higher than expected oil demand from emerging markets, and in particular from China, which on some estimates is expected to have accounted for between 30% and 40% of the increase in oil consumption this year. Thus there has been a fairly close empirical relationship between Chinese demand (in the form of Chinese oil imports) and the price of oil per barrel. It follows that any China slowdown should help moderate demand, and price, somewhat. And vice versa, of course.

Interestingly, the correlation between Chinese imports and the oil price appears to have broken down around June of this year. At the same time, there has also been a structural break in the relationship between oil price changes and changes in oil inventories (shifts in demand relative to supply should lead to changes in inventory levels).[18] One implication is that since around about the middle of this year, the spike in prices has reflected more of a (political) risk premium in energy prices than demand factors. So if this risk premium drops out, there is the possibility of a significant price fall next year. However, the political situation in the Middle East is such that there is clearly no guarantee that the premium will fall in this manner. Indeed, there is presumably at least some risk that it could go the other way. Meanwhile, the fact that spare global oil capacity is again estimated to be relatively low in comparison to forecast demand next year implies continued tight market pressure, and the risk of further price spikes.[19]

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[18] Michael Dicks, *Where next for the oil price?* Global Weekly Economic Monitor 29 October 2004. New York, Lehman Brothers, 2004.

[19] There are also some potentially interesting feedback effects here between the possibility of a US dollar correction and the risk of higher oil prices. Oil prices are set in US dollars, and a rise in prices has therefore tended to be associated with an increase in the demand for dollars. Historically, this has meant that oil importers like Europe and Japan have suffered from a 'double whammy' – higher oil prices have tended to mean higher US dollar prices, and weaker currencies against the US dollar. However, this time around a weaker greenback could work to offset the impact of higher prices in US dollars. See for example Nouriel Roubini and Brad Setser. *The effects of the recent oil price shock on the US and global economy.* 2004: http://www.stern.nyu.edu/globalmacro/OilShockRoubiniSetser.pdf.

Finally, a closely related risk is that the adverse impact of higher oil prices on the world economy could turn out to be greater than is currently forecast.[20]

Summing up

In conclusion then, a reasonable scenario for the global economy next year would call for some moderation in the pace of global growth, but leave output growing at or near the historical trend. However, the realisation of that forecast will require the world economy to successfully manage the risks associated with a series of economic imbalances.

[20] For example McKibbin and Stoeckel present results indicating that the impact of a US$10 per barrel price hike on OECD real output may be up to 50% greater than the IEA estimates cited above (although they also find a smaller impact on inflation). Warwick McKibbin and Andrew Stoeckel, Oil price scenarios and the global economy. *Economic Scenarios* (9) 2004. Roubini and Setser also argue that the conventional wisdom has tended to underestimate the hit to growth from higher oil prices. Roubini and Setser. *The effects of the recent oil price shock on the US and global economy.*

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