World economy: No smooth path to growth in 2004

Nick Beams
3 January 2004

According to the latest indices, prospects for the world economy are brighter than at any time over the past five years. Stock markets have been on the rise with Wall Street enjoying its best year since 1996 and Tokyo its best since 1986; the US economy is experiencing a recovery, with growth predicted to be between 3 and 4 percent over the next year; the Japanese economy is showing signs of expansion; and recessionary trends appear to be easing in Europe.

In a recent editorial, the *Financial Times* even held out the prospect that for the US there could be a return to the "Goldilocks economy"—that period in the late 1990s when it was claimed growth was "just right", that is, not to great to bring inflation, yet large enough to ensure an expanding jobs market.

If one probes beneath the action on the stock markets and the immediate economic data, however, it is clear that far from embarking on a smooth path to growth, the world economy has entered a period of profound disequilibrium.

At the heart of this destabilisation is the indebtedness of the United States which accelerated in 2003. The current account deficit for the year is expected to reach a record $550 billion, equivalent to more than 5 percent of gross domestic product (GDP), taking the US external debt to around $3 trillion, or close to 30 percent of GDP.

In a speech on monetary policy delivered on November 20, Federal Reserve Board chairman Alan Greenspan pointed to the "growing concern" over the current account deficit and the possibility that the rising stock of external debt "could become increasingly more difficult to finance."

With the ratio of external debt to GDP currently rising at the rate of 5 percentage points a year, Greenspan warned that while the financing of this debt had so far been "seemingly uneventful" there would have to be "future adjustments" if it continued to rise. "How much further," he asked, "can international financial intermediation stretch the capacity of the world finance to move national savings across borders?"

A report issued by the Financial Markets Center shows the extent of this operation. In 2002, it noted, net capital inflows to the US were $528 billion, representing 75.5 percent of net capital outflows from the rest of the world. The figure for 2003, given the widening in the current account deficit over the past 12 months, is likely to be even greater.

Figures provided by the Japanese government on intervention in currency markets aimed at trying to stabilise the value of the yen give another indication of the size of the financial flows. Seeking to slow the rise of the yen against the dollar and thereby protect export markets, the finance ministry spent a record 20,057 billion yen (equivalent to more than $180 billion) this year, more than two and a half times the previous record set in 1999.

Further interventions are planned with the finance ministry announcing that it would raise the amount it can borrow for currency interventions until the end of the fiscal year in March by 21,000 billion yen to 100,000 billion yen. For the fiscal year starting in April, the borrowing limit has lifted by 61,000 billion yen to 140,000 billion yen—the increase being almost equal in size to the US current account deficit.

The massive Japanese intervention is only the most graphic expression of a process which has become the dominant feature of the international financial system. As the US dollar comes under pressure in international markets—it has fallen on average by about 11 percent this year—Asian central banks are intervening to try and prevent a rise in the value of their currencies in order to protect their export markets. In turn, their purchases of US dollars finance the balance of payments deficit and the US federal budget deficit which is set to go over $500 billion.

An article by global economist David Hale in the *Australian Financial Review* of December 29 pointed out that east Asian central banks now hold 70 percent of the world's foreign exchange reserves of $1.7 trillion. They have invested some 80 to 90 percent of these reserves in the US government bond market and are effectively funding the US budget deficit. So far the financing operating has proceeded relatively smoothly. But if the central banks were to rapidly withdraw their funds, either for political reasons, such as retaliation against protectionist measures initiated by the US, or because of fears of a collapse in the dollar's value, a major financial crisis would result.

Analysing this process in an article entitled "Upside down logic", published on December 28, *Financial Times* columnist John Plender noted that the world economy was now engaged in an "unprecedented high-wire experiment."

"Having relied chiefly on private capital to finance the deficit in the late 1990s, the US is now dependent on official flows from Japan, China and other emerging Asian economies to keep its fiscally profligate, dollar-denominated show on the road. This is the opposite of the way global capital behaved in the earlier episode of free capital flows before 1914. Then the UK ran huge surpluses on external accounted and exported capital to developing countries. Today, the world's richest economy has turned this logic on its head. So we have a paradox ... of a unilateralist-inclined America depending for its high domestic consumption and pursuit of interventionist foreign policy on the largesse of such implausible friends as the People's Republic of China."

The disequilibrium of the world economy is reflected not only in financial data but also in growth figures. According to Morgan Stanley global economist Stephen Roach, over the period 1995-2002 the US accounted for 96 percent of the cumulative increase in world GDP—some three times its 32 percent share of the global economy.

Describing the world economy as "very much in a state of fundamental disequilibrium," Roach noted that "an unprecedented disparity" has opened up between nations with current account deficits, principally the US, and those with surpluses, Asia and to a lesser extent, Europe. Not only are such global imbalances unsustainable but in the US, a "lasting recovery cannot be built on a foundation of ever-falling saving rates, ever-widening current-account and trade deficits, and ever-rising debt burdens."

It is impossible to forecast exactly how these imbalances, and the tensions they generate, will unravel in 2004 and beyond. But one thing can be said with certainty: the longer the world economy continues on the present path, the greater will be the underlying disequilibrium and the possibility of a major financial crisis.