RISKS AND THREATS TO THE PRESENT WORLD ECONOMIC RECOVERY

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The recent deceleration of growth in the industrial countries, due to the end of the financial bubble provoked by the over expectations created by the New Economy, has been the less intense of the last 30 years, but in the case of the US the cyclical component has been larger than the trend component and in the case of the EU the other way round. The proof is that the fall in the US GDP was three times larger than in the EU and its recovery is being much faster. After growing at 0.5% in 2001 versus 1.6% in the EU, the US has been growing at a speed three times faster than the EU in 2002 and 2003.

The recovery is also very different in both economies, mainly due to the fact that the demand macro-policy has been much more vigorous in the US than in the EU. Between March 2000, the initial bursting of the financial asset bubble, and today, the US fiscal policy impulse has added 6% of GDP and the monetary impulse has been equivalent to 4% of GDP. On the contrary, in the EU the fiscal expansion has been only of 0.5% of GDP and the monetary impulse has been equivalent to 1.5% of GDP. Thanks to this aggressive US macro-policy the world recession has been avoided, given that, since 1995, 55% of the cumulative growth in world output has come from the US, nearly twice of the US share of world GDP. Domestic demand has increased, on average since 1995, by 3.7% annually, twice the pace of the ensemble of the OECD countries. On the other side the EU has done very little to prevent a world recession, it has contributed less than 10%, less than China, with 12% and much less than the rest of the world, with 36%, given that Japan has subtracted more than 12% to world GDP.

We are heading to a recovery that looks to be, in principle, quite robust. After growing at an average of 3.2% between 2001 and 2004, world growth is expected to reach 4.1% in 2004; up from 3.2% in 2003, and, according to the IMF, it could achieve an annual average of 4.3% from 2005 to 2008. Advanced economies will grow 2.9% in 2004 and 4.8% in the next 4 years. Developing countries are expected to grow 5.6% in 2004 and 7.8% in the following four years and countries in transition will grow 4.7% in 2004 and 8.1% thereafter. At the same time, consumer inflation will keep a downward trend. Advanced economies will have 1.3% in 2004 and 2% in the following 4 years. Developing countries will come down from 5.9% in 2003 to 4.9% in 2004 and to 4% thereafter and countries in transition from 9.7% in 2003, to 9.1% in 2004 and to 4.9% in the period 2005-2008. Even the current account balances of the balance of payments will improve their present disequilibria. According to the IMF the advanced economies are likely to reduce their negative balance from –0.8% of GDP, between 2001 and 2004, to -0.6% of GDP, between 2005 and 2008. Developing countries and countries in transition will reduce their surpluses accordingly. The US is expected to reduce its deficit of current account from the present 5.1% of GDP in 2003, to 4.7% in 2004 and to less than 3% at the end of the following four-year period.

Nevertheless, the most important issue to be solved ahead is that the world cannot continue to rely on US spending. The chances are that US citizens themselves will eventually start to save more, and, even if they do not, foreigners will become increasingly unwilling to fund US spending. During the 1990s boom, US firms were the ones that powered the global economy with a huge debt-financed investment spree. But after the stock market

crash in 2000, investment spending collapsed as firms tried to strengthen their balance sheets. Since then, total spending has been growing in part because US households have kept borrowing, because the sharp cuts in interest rates by the FED which have go down to 1%, the lowest level in the history of the US, allowing them to borrow against their homes. But they have yet to make that adjustment to their low level of net savings, given that their current indebtedness is growing twice as fast as their incomes. Increasingly, the US Government has been fueling spending. The federal budget deficit has shifted from a surplus of 2% of GDP, in 2000, to a deficit of 4% of GDP in 2003, but even bigger deficits will not able to compensate for a drop in household spending. Moreover, such spending, which was, fundamentally, financed by foreign private investors is now being financed mainly by foreign central banks. Asian central banks are the largest foreign investors in US Treasury bonds, with China, Japan, South Korea and Hong Kong owning a combined total of 700 US $ billion. At present overseas holdings of US bonds have hit a record of 46% of the total, to this figure it has to be added foreign holdings of 17% of US corporate debt.

The main reason why the Asian central banks have been buying US bonds is that they have been intervening massively, buying dollars to avoid an appreciation of their currencies as soon as the dollar has started to fall. Therefore, their current account surpluses with the US have been recycled into the US through the purchase of US securities. The huge accumulation of dollar reserves needed to be sterilized by the central banks through such purchases to avoid a too large increase in their domestic monetary base.

The solution to this major imbalance that is unsustainable in the medium term is that, either US citizens spend less or foreigners spend more or the dollar has to fall further or a combination of the three. Let us look at these three solutions, that is a smooth adjustment, a postponed adjustment and a sharp and brutal adjustment:

Ideally, the best solution would be a smooth adjustment, in which foreigners make most of the adjustment by increasing their spending and leaving the fall in the dollar to do the rest. If the non-US world increases its domestic demand it will increase imports from the US helping to reduce its excessive current account deficit. This was the solution achieved in the mid eighties, when President Reagan increased heavily its spending by borrowing from foreigners and pushed its current account deficit to 3% of GDP. The booming demand from Europe and Asia, but mainly by Germany and Japan, and a controlled depreciation of the dollar thanks to the Plaza Accord among central banks made possible to adjust the imbalance without producing a global recession. Nevertheless, this time is very difficult to reach such solution. First the imbalances are much larger and more entrenched and the rest of the world economy is more fragile. There are no other alternative locomotives and there is not a smooth way to bring down the dollar.

The EU and Japan should be the most likely motors of the global economy, but their growth is very weak and they need urgently large reforms in the product markets and in the production factor markets. Japan is slowly coming out of a decade of recession or stagnation and deflation. In the EU, the recovery is also slow, mainly because an obsession with a tight macroeconomic policy. Nevertheless, there are some signs of change and improvement in both economies, where reforms are starting to be implemented, although slowly, but they have still a long way to go, before they can reach their previous level of potential growth.

The second solution is a smooth adjustment via a drop in the domestic demand of the US, which is a possibility as soon as US households start increasing their savings in order to redress their heavy indebted finances and the US government starts to reduce the huge

budget deficit, most probably after the elections (both in the case that Bush is reelected or the Democrats take over the government) to avoid a necessary and painful strong increase in taxes. The reduction of foreign financing of the current account deficit and the financial markets both imposing a strong adjustment through an increase in long-term interest rates could be the sparkle that provokes such a new rebalancing process. The problem with this solution is that it should be gradual, giving time to the rest of the world to consolidate its actual weak recovery and increase its domestic demand. Nevertheless we know by experience that both financial markets and individual households tend to react very quickly once they start to lose confidence in the US economy and are afraid of new dip in US growth, accelerating a recession that could be deadly for the rest of the world in the middle of a weak recovery. Therefore this solution should be complemented by a controlled drop in the dollar with the help of a new Plaza Accord. It would need, not only a massive intervention by central banks to smooth its fall but also some help by the EU relaxing its present monetary and fiscal policy. Both measures are very difficult to be implemented given the present uneasy mood at both sides of the Atlantic.

The third solution is a postponed adjustment followed by hard and deep fall in the dollar, that is, a strong adjustment. This will be the worst of the solutions. If the US continues to follow its massive fiscal and monetary easing beyond the elections and growing at 4% it could achieve to maintain the value of the dollar temporarily and be able to finance a growing current account deficit, although temporarily, until the foreign investors start to lose confidence in the US economy because they see that the trend is unsustainable. That would trigger a strong fall in the dollar with all the negative consequences for the rest of the world and for the US economy. This outcome will generate a world recession. Nevertheless, this does not look to be the case. At the recent annual meeting of the IMF in Dubai, the Group of 7 has made an strong statement indicating that “more flexibility in exchange rates is desirable in major countries or economic areas to promote smooth and widespread adjustment in the financial system, based on market mechanisms”. This statement has been strongly supported by the Euro Area, given that the euro is, at present, taking most of the burden of the adjustment through a strong appreciation of the euro, while Japan, China and other Asian countries continue to intervene massively to avoid their currencies to appreciate. At present, measured in effective exchange rates terms, weighted by trade, an 8% depreciation of the US dollar is equivalent to a euro appreciation of almost 20%.

The problem with this solution is that, on the one side, further appreciations of the yen would threat Japans fragile recovery and on the other side China will not accept a revaluation of the yuan unless the rest of the Asian countries do the same. Moreover, China has not a large trade surplus and its economy, despite fast growth is still very fragile. Its banking system is bust and growth is very unevenly distributed creating major inequalities between the coast and the urban areas and the rest, where most of the population lives, therefore a strong appreciation of the yuan could reduce the speed of the Chinese growth rate and provoke a final collapse of its banking system, which will cost between ten and fifteen percentage points of GDP and serious political problems to the Government. Eventually, the Asian countries will have to let collectively their currencies appreciate because, if they do not do it, the US will start to impose heavy tariffs an quotas on their imports in the months previous to the elections, given that in the past three years US manufacturing has lost almost three million jobs, one out of six in that sector. Therefore there is an increasing public demand for protection both by US unions and citizens, enough to switch an important percentage of the US electorate to back these protectionist measures and to vote for the Republicans.

To sum up, the way the present US imbalances are going to be adjusted is still quite uncertain and could be a problem for the world economy. The risks of a dollar crash or a

serious global recession have a very low probability, but they cannot be dismissed totally. Nevertheless, my personal view is that this recovery could be gradual but sustainable.

The main reasons to support this view are the following: First, the recovery in domestic demand appears to be more broadly based. There are increasing signs of demand growth outside the US, particularly in Europe and Asia. A broad-based recovery in the G3 domestic demand with a further weakening of the dollar would increase the chances of a more balanced recovery. Second, the balance sheet repair process is advancing further. The US private sector financial balance currently stands at 0.1% of GDP, considerable better than the –5.5% of two years ago and business in particular seem to have completed the adjustment to the posy-bubble environment and should be much better placed for at least a moderate increase in spending. Third, Global equity markets have performed more strongly over the last few months, showing expectations of a sounder recovery and contributing to easier financial conditions. Fourth, financial conditions have eased significantly in the US both through a drop in interest rates a weakening in the dollar and an improvement of equity markets. Fifth, the probabilities of China and other Asian countries allowing their currencies to appreciate are growing and it could happen in the next few months. If such were the case, it would ease financial conditions both in the US, helping the dollar to fall further, and in the EU, allowing the euro to appreciate less, helping to rebalance global demand.