The world economy

Scares ahead
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Can the world economy sustain its stunning pace of growth?

MOST people cannot remember when the world economy last grew so rapidly. The International Monetary Fund now reckons that real global GDP is likely to increase by 5% this year, its strongest pace for a generation. That growth has been led largely by the twin engines of robust consumer spending in America and booming corporate investment in China, but Japan's recovery has also been stronger than expected this year and even the euro area has perked up. Emerging economies as a group are enjoying their fastest growth for at least 25 years. It would hardly be surprising, therefore, if the world economy slowed next year. But will it slow gently or crash into a wall?

The IMF expects global growth to run at a still healthy 4.3% in 2005. Other official organisations, such as the OECD, the Federal Reserve and the European Central Bank, are also optimistic about the health of the global economy over the coming year. We hope that they are right. But history suggests that when things look so rosy, one should always ask “what might go wrong?”. There are four main risks: higher oil prices, a slump in America's consumer spending, a global house-price bust, and a hard landing in China.

Oil prices hit a record $50 a barrel this week, well above the average price of $37 on which the IMF bases its forecast. Oil matters less than it once did, and in real terms oil prices are still well below their previous peak, yet oil prices still have the power to hurt the world economy. If they remain at current levels or even climb higher, corporate profits and household real incomes will be squeezed. The IMF reckons that a $10-a-barrel rise would trim global growth by 0.6%.

Oil currently tops everybody's worry list, yet a more serious risk to the world economy is that overindebted American consumers may be forced to tighten their belts. Consumer spending has already slowed quite sharply, but the conventional wisdom in America argues that the economy is merely going through a brief "soft patch", from which it will soon rebound. Such forecasts assume that this is a normal recovery, even though the figures suggest otherwise. Since the trough of the recession in November 2001, America's labour market has seen its weakest recovery for half a century; total real wages and salaries have increased by a mere 3% compared with an average gain during the equivalent period of the previous six recoveries of over 10%. Yet even as wages have stalled, consumer spending has surged by 9%, supported by a massive monetary and fiscal stimulus. Tax cuts have lifted incomes, while negative real interest rates have encouraged households to borrow and have helped to boost
house prices.

This stimulus is now fading, and both John Kerry and George Bush say they would cut the budget deficit by half over the next presidential term. Even if they fail, as seems likely, fiscal policy is likely to be mildly restrictive over the next year or two, at the same time as interest rates are rising. Household saving has fallen to a record low of less than 1% of disposable income and surely cannot fall further; more likely it will rise. In recent years, big gains in the prices of shares and, more recently, homes have boosted household wealth, so consumers have felt less need to save. Surveys suggest that they expect double-digit average annual returns from both shares and houses over the long term. This is wildly unrealistic; households are underestimating how much they need to save for retirement. Sooner or later they will have to save in the old-fashioned way, out of income rather than relying on capital gains. If the saving rate reverted to its long-term average of 8% over the next 5-10 years, a relatively gentle adjustment, consumer spending would have to grow 1% a year more slowly than income, the exact opposite of what has happened in recent years. In fact, there is a risk that saving could rise more swiftly, especially if overvalued house prices fall. More saving, at whatever rate, is bound to dampen growth.

That brings us to the third risk to the world economy, namely that the global house-price boom could turn to bust. Never before have real house prices been rising so fast in so many countries. In almost two-thirds of the world economy, housing markets look unusually frothy. Indeed, the world may face its first-ever global house-price bubble, and if it bursts it will hurt economies much more than the collapse in share prices did at the start of this decade, for houses are more widely owned than shares.

The fourth risk is that China's soaring economy might suffer a hard landing as its investment boom turns to bust. A slump in China would badly hurt the rest of Asia, and dent global confidence. China's GDP surged by almost 10% in the year to the second quarter, and fixed investment and bank lending are still rising too fast. The government is reluctant to use the usual macroeconomic policy tools of a market economy, such as letting the exchange rate rise and raising interest rates; instead it has relied mainly on administrative controls to curb lending and investment. Negative real interest rates are distorting market signals, and the bluntness of direct controls runs the risk that investment may mistakenly undershoot.

**Global yin and yang**

The finance ministers and central bankers of the G7 group of rich economies are likely to urge China to adopt a more flexible exchange rate when Chinese officials attend part of the G7 meeting in Washington, DC, on October 1st. This is the first time that China has been invited, a recognition of the country's growing economic clout. China is the world's second-biggest economy (measured at purchasing-power parity) and it has accounted for almost one-third of the world's real GDP growth over the past three years—a bigger share than America.

China poses a short-term risk over the next year or so, but looking further ahead that country's integration into the world economy is likely to remain a powerful driver of global growth. Our survey in the centre of this issue explores the many ways in which China's emergence is affecting the world economy. Currently, the most obvious feature is that the hungry dragon has a huge appetite for energy and raw materials. The 40% jump in China's oil imports this year is partly responsible for higher world oil prices. This is why one should not worry about both higher oil prices and a hard landing in China: if China's growth slumped, so would oil prices, unless the Iraq conflict spreads so widely as to threaten Saudi Arabian output. A slowdown in America would also push oil prices lower. In that event, cheaper oil would, in turn, help to offset the impact of weaker Chinese and American demand on Japan, Europe and other emerging economies.
There are also other positive factors that could help to offset a slowdown in America and China, and so prevent a global slump. While America's huge imbalances imply that its economy must eventually face several years of much slower growth, other parts of the world could surprise on the upside over the next few years.

It is fashionable to write off the euro-area economies as sluggish and unable to change. Europe's GDP growth has certainly been slower than America's in recent years—both in the 12 euro countries and in the rest of Europe. But this is largely due to weaker consumer spending, because European households have not borrowed up to the hilt and run down their savings. The average household saving rate in the euro area stands at around 10%, against less than 1% in America. Suppose increased liberalisation and competition in Europe's financial markets made it easier for individuals to borrow—as in America—while rising employment, thanks to continuing labour-market reforms, boosted consumer confidence. If so, then a fall in the euro area's saving rate could boost consumer spending and hence overall growth—exactly as it has done in America over the past decade. At present, most of the risks to the world economy lie on the downside—but not all.