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Calm Before the Storm

Despite good news from the world's largest economies, there is no euphoria, anywhere. Here's the oddly troubled outlook for 2004.

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The global growth engine is finally moving into high gear. Driven by the United States, fueled by soaring demand in China and boosted by reform in Germany, France and Japan, the world seems poised for expansion in all its major economies. The next four to eight months look very promising, according to forecasters just about everywhere.

Yet an undercurrent of worry remains. In the past two years, the rare simultaneous downturn in all the major economies produced uncertainties that still haunt the recovery. For different reasons--overheating in China, rising deficits in the United States, runaway spending in Europe--there is a strong possibility that central banks will be compelled to raise interest rates and choke the recovery. While emerging markets are enjoying a stock-market boom, it is driven largely by a perceived shortage of opportunity in major markets, and could quickly dissolve in capital flight. Threatening everything are political tensions among the major countries over issues ranging from terror to trade and currencies. No major country is content with the value of its currency, and there is no mechanism to satisfy them all--a situation that could easily lead to crisis in 2004. So my New Year's message is: enjoy the moment, but be skeptical about rosy long-term projections.

The United States: There is lots of good news--8.1 percent growth in the last quarter, the highest levels of productivity in 20 years, expansion of manufacturing, an unemployment rate that has declined from 6.4 to 5.9 percent. Corporate profits have soared, business investment is beginning to revive and the Dow has risen to pierce the symbolic 10,000 mark on more than one occasion. All this is happening with low levels of inflation, too. The Organization for Economic Cooperation and Development (OECD) projects U.S. GDP growth in 2004 of 4.2 percent, compared to 2 percent this year, and some forecasters are even more optimistic.

There is no mystery why this recovery has occurred. The economy is inundated by stimuli--the lowest interest rates in 40 years, the largest tax cuts in memory and consumers who just can't stop buying big-ticket items. Companies have streamlined for fierce competition. Nevertheless, in pushing massive new tax cuts combined with big spending hikes on everything from military readiness to health insurance for seniors, Washington has almost guaranteed unprecedented fiscal deficits for many years to come. Goldman Sachs sees this red ink going as high as \$500 billion next year, a 20 percent increase over the unprecedented 2003 levels. At the same time, Uncle Sam has been running trade deficits so large that it needs to borrow about \$2 billion per day from foreign lenders. HSBC, the global bank, says that amount could easily double in a few years. The single biggest danger to the U.S. recovery is that these two deficits will drive up interest rates and thereby choke off growth.

There is a good chance rate hikes will come by the end of 2004, when a number of factors could converge. Economic growth will be strong. President Bush will be making new spending commitments to assure his re-election. In this situation, the Federal Reserve could move to tighten credit to ward off the specter of inflation, or the bond markets could act on inflation fears and drive up long-term rates. Economic activity abroad will be picking up, too, and overseas

investors may redirect funds away from the United States--or at least demand higher interest rates from American borrowers.

China: Asia is likely to generate more than half the growth in global trade this year, and China will account for most of that. U.S. sales to China have been growing at more than 20 percent per year. Two thirds of Japan's exports now go to the People's Republic. Beijing's soaring demand has forced up global prices for everything from beef to oil to shipping rates. Truth is, no nation has ever sustained such extraordinary growth for so long, and China is due for a setback.

The key threat: overheating. The property, automobile and export sectors have been growing at a 30 percent annual rate since 2001, overall investment is running at more than a third higher this year than last and the money supply is growing much too fast. Indeed, the central bank is already urging more caution on bank lending. Look for more retrenchment in 2004.

Japan: The world's second largest economy has been in a slump for a decade, and because it exports far more than it buys from the rest of the world, it has not been a source of global stimulus for some time. In 2004, however, Tokyo could experience a mild rebound, with growth of 1.8 percent, according to the OECD. The economy has grown for seven straight quarters, and the stock market is up about 25 percent since March. The threat of serious deflation seems to be subsiding, and at last Tokyo is cleaning up its debt-burdened banks. Nevertheless, Japan has had many false starts, and there is a good chance that, once again, powerful farm and construction interests will obstruct reform. Export dependence also makes Japan hostage to the fortunes of the Chinese and the U.S. markets. Don't hold out too much hope for this one.

Germany and France: The European Union constitutes about 30 percent of global GDP, and France and Germany account for about half of that. The OECD is forecasting EU growth on the order of 1.8 percent in 2004, compared with 0.5 percent this year. This projection assumes reforms begun in 2003 will continue: Germany will implement significant tax cuts, reform the state pension system, reduce unemployment benefits and allow more part-time work, and France will move in similar ways to cut social programs and create more flexible work rules.

Even if such reforms gain momentum--a big "if"--there is a more immediate challenge. Fiscal discipline in the European Monetary Union was shattered when Berlin and Paris violated the stability-pact commitment to hold fiscal deficits under 3 percent of GDP. Unless a new disciplinary mechanism is found soon, odds are that the European Central Bank will raise interest rates to offset uncontrolled spending and defend its credibility as an inflation fighter. The major constraint on the ECB: raising rates would further strengthen the rising euro, which hurts European exports and slows economic growth.

Emerging Markets: By the end of 2003, these countries are likely to have raised twice as much in the global bond markets as they did in either of the previous two years. Emerging-stock-market indexes are up on the order of 30 percent this year, too, with countries such as Brazil and Argentina up more than 100 percent in dollar terms. The question is, how long can this bonanza continue?

The good news is that since the financial crisis of the late 1990s that engulfed Asia, Latin America and Russia, reforms have made another crisis less likely. Many emerging markets have established more flexible exchange rates, higher levels of financial reserves and more transparent accounting. Even after deep recession in Argentina, political meltdown in Venezuela, or the jailing of Russia's top CEO, the problems in one emerging market have not spilled over into another, as they used to.

On the other hand, a huge portion of investing in emerging markets has occurred because of the lack of profitable opportunities in the industrialized world. In this environment, emerging-market investors are chasing the highest possible yield, while lowering their guard against risk. As growth and interest rates pick up in the industrial world, emerging markets could see a slowing down of capital inflows, if not a reversal. Many have high debt levels and could be forced to rein in their economies.

Currency Crisis: As we begin 2004, no major country is comfortable with where its currency is vis-a-vis the others, either because it would like it to be lower or because it is under serious political pressure from others to revalue. However, very few good options exist for changing the status quo.

In mid-December the dollar was testing record lows against the euro and the British pound, and was also quite low vis-a-vis the yen. Washington wants the dollar to continue to slide, because

that would make U.S. exports more competitive, raise import prices and take some of the pressure off the trade deficit. But it naturally wants this to happen very gradually to prevent the world's leading currency from setting off a major financial crisis. Controlling depreciation is no easy feat, however, as once markets tend to move in one direction, they often gain momentum that is hard to stop.

In 2004, moreover, the United States will continue to pressure China to allow its currency to float upwards. Beijing is resisting, for fear that the Chinese economy could be destabilized. The United States will press Tokyo to stop artificially depressing the yen, but Japan fears that doing so would kill its modest recovery. Meanwhile, the result of cheap dollars, yuan and yen will put upward pressure on the euro, which, as noted above, will distress European exporters and undermine European growth.

It wouldn't take much to create a crisis in this tense environment. Suppose China, with its nearly \$400 billion in reserves, decided to move part of its funds out of dollars into other currencies, simply as a prudent diversification strategy. Other countries might decide to follow Beijing's lead, causing the dollar to decline at a rapid rate. Or suppose OPEC countries, which now price their oil exports in dollars, switch to charging buyers in euros--or some combination of dollars and euros--thereby damaging confidence in the U.S. currency and also driving it down at a rapid rate.

The management of all of these issues is less about economics than about international political cooperation. On the global scene, every country is now out for itself--to a degree we have not seen in generations. There is ample evidence of this beggar-thy-neighbor mentality in the breakdown of global-trade negotiations and the diminishing enthusiasm for international organizations. The kingpin of the system, the United States, has turned unilateralist and is flirting with trade protection, most recently by excluding opponents of the war in Iraq from bidding on big reconstruction contracts. Europe is preoccupied with internal challenges, from the ratification of its constitution to incorporation of new members, and has shown a high level of disregard for the international economy by maintaining sky-high farm subsidies that hurt developing nations. Japan has never made much of a conscious international contribution and shows little sign of change. China is focused on its own growth and social stability.

If there is an economic setback or a crisis of any kind, the current state of global politics could become a big problem. As 2004 approaches, this should be our biggest concern.

A German steel plant and a U.S. power station
Scottish petrol plant; Chinese autoworkers