

*Center for the Study
of the Presidency*



*Issue Papers
For the New Administration*

#6 “Notes on the World Economy”

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“Although the US remains the chief engine for restoring world growth, it is itself vulnerable to adverse economic and financial developments around the world. Social and political upheaval, often with military consequences, have blighted the world in past times of global economic disorder or decline. The Administration needs to recognise these realities in its own policy making structures in a fashion that takes into account the inter-linkages between political, economic and financial issues and the relatively greater role played today by private sector forces.”

*In **Triumphs and Tragedies of the Modern Presidency** (Praeger, 2001), the Center analyzed Presidential leadership through the lens of more than seventy-six case studies. These **Issue Papers** are a forward looking complimentary series of short, single-author papers that frame and briefly analyze key issues that the next President must address during the early months of his Administration. Views expressed in these papers are those of the authors.*



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NOTES ON THE WORLD ECONOMY

July 2001

The world economy is more dependent than ever on the US as an engine of growth. The following brief summary of current world economic conditions underlines the need for strong US leadership in today's multi-centered, highly interdependent and brutally competitive global economy and financial system. The implications for how US global economic policies are developed and implemented are profound, not only for US bilateral initiatives but also for US policy approaches towards the world's multi-lateral institutions and within the various groupings of nations such as the G7.

The US weighting in G3 GDP rose 4.3% between 1992 and 2000 while Japan and the EU12 declined by 2.6% and 1.7% respectively, because US growth outpaced the rest of the OECD. The world economy is becoming more integrated - international trade rose from 37.5% of OECD GDP in 1984 to 48% in 2000, which amplifies the effect of a downturn in the world's largest economy. As a result, the decline in US annual import growth from a cycle peak of 23.7% in March 2000 to 1.4% in April 2001 has depressed growth prospects everywhere. This in turn has grave implications for world capital flows and the functioning of global financial markets.

Recent US data indicates that consumer demand remains solid while manufacturing is beginning to recover, although tech related investment is still contracting and the inventory adjustment is incomplete. Pre-emptive and aggressive monetary easing has forestalled a contraction in consumption, and limited contagion from the manufacturing recession to the broader economy. Further, tight labour market conditions mean that employers are reluctant to fire workers who may be difficult to replace once business conditions improve. This remarkably rapid and relatively painless adjustment to an overshoot in tech related investment and a steep decline in equity market valuations highlights the dynamism and flexibility of the US economy. US population and labour force growth is also more rapid than in Europe and Japan while the median age is younger, so underlying growth in consumer demand is stronger. The 0-19 age group accounts for 28.3% of the US population, compared to 22.4% in Europe and just 20.4% in Japan. A relatively open US immigration policy has proven to be a strength by expanding the labour force in general as well as improving the skills base of the economy.

Europe is weakening in response to the US downturn, although the euro has depreciated by 12% and fiscal policy has eased. Leading economists continue to revise down the 2001 GDP growth forecast to under 2%. Germany is the weakest economy, hurt by a sharply contracting construction sector and by inappropriately high interest rates. The ECB is struggling to manage a one size fits all monetary policy, as growth in some economies like Spain and Ireland is

high, while inflation (May 3.4%) is well above the ECB's 2% target. The euro is proving to be a vehicle for structural reform and industrial consolidation within Europe, as a single currency greatly improves price transparency.

Japan's economy looks set to stagnate for a further 2~3 years if the Koizumi restructuring program is implemented. The economy is still deflating, and many economists estimate that non-performing loans (NPLs) held by Japanese banks currently total ¥76.5 trillion (\$616bn). This is equivalent to 17% of total bank lending and 15% of nominal GDP. A key element of Koizumi's economic policy is the accelerated disposal of massive amounts of NPLs over a short 2-3 year time span, so the economy is likely to suffer a sharp contraction in output and demand.

The emerging economies are becoming more and more vulnerable to slower OECD growth via weaker export demand and an associated rise in the financial market risk premium. These economies need help to become engines of world growth as otherwise the US will face sclerotic major trade partners with ageing, shrinking populations unless the EU and Japan adopt structural reform and more open immigration policies.

Latin America's growth projections for 2001 are also being revised downward in every country in the region. Argentina's recently successful debt exchange secured a valuable breathing space for Argentina to implement greater fiscal discipline and important measures to stimulate growth. However, political wrangling and declining growth in foreign markets have damaged Argentina's prospects and undermined investor confidence so that Argentina's bonds are now trading at default levels (yields above 30%). Finance Minister Cavallo's proposals to eliminate the fiscal deficit have been greeted by markets with scepticism that Argentina can recover from recession and service its debt burden. Risk has spread to Brazil, where the real has depreciated sharply, despite aggressive monetary tightening and FX intervention. Regional growth will reach only 2.2% this year, roughly half the expansion recorded last year. **NAFTA** has been an outstanding success for Mexico and other Latin American countries could benefit from membership.

Asia and Mexico are the emerging market economies most affected by slower US import demand. The collapse in US new orders for computers and electronic products (-35.6% y/y May) is amplified in **Asia** where electronics account for one-to two-thirds of total exports. Growth has been revised down to one-third 2000 levels except in China while Taiwan and Singapore are close to recession. Governments have few policy options to offset weaker exports. Most Asian countries still have impaired banking systems, limiting the capacity of easier monetary policy to stimulate growth, while high debt levels prevent governments from easing fiscal policy. **Turkey's** difficulties in meeting IMF program requirements have pushed T-bill rates towards 100%, raising the prospect of default or hyper-inflation.

The following table highlights the risks to recovery. Analysing six risks to global growth, CSFB's economists see weakness in US demand still as the greatest danger, followed by emerging market crisis.

WHAT CHANCE IS THERE THAT THESE RISKS EVENTUATE?

Risk		Probability of risk occurring	Probability monetary policy ineffective
1. US investment worse than expected	Biggest danger due to tech overhang, soft profits & high inventories.	5/10	6/10
2. US consumption worse than expected	Main vulnerability is if investment collapses.	3/10	1/10
3. Inflation constrains central banks	Risk receding as soft world erodes oil & metal prices.	2/10	NA
4a. Asia weaker than expected	Excluding Japan, domestic policy free to counter US weakness.	3/10	1/10
4b. Europe weaker than expected	Weak € limits export damage but increases inflation.	2/10	5/10
5. Disruptive financial event	Risky moment of cycle approaching, emerging market strains.	4/10	2/10
6. Global imbalances escalate	Risk has risen in emerging economies.	3/10	6/10

Although the US remains the chief engine for restoring world growth, it is itself vulnerable to adverse economic and financial developments around the world. Social and political upheaval, often with military consequences, have blighted the world in past times of global economic disorder or decline. The Administration needs to recognise these realities in its own policy making structures in a fashion that takes into account the inter-linkages between political, economic and financial issues and the relatively greater role played today by private sector forces.

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16 July 2001