The perfect wave

The global economy is set to record a third consecutive year of below-par growth in 2003. Next year it should do better, despite some storm clouds on the horizon.

The world economy had to battle several headwinds during the first half of 2003. These included a rise in energy prices, geopolitical risk prompted by the war in Iraq and the outbreak of the SARs epidemic in East Asia. In addition, economies and policymakers were still dealing with fallout from the end of the 1990s asset price bubble – the largest in history. The consequences of this are still being felt, with Lehman Brothers, a US investment bank, estimating that spare capacity in the global economy remains at a 10-year high.

The good news, however, is that as several of these headwinds have dissipated, the tailwinds driving global growth have gathered force.

Most important for global growth is the way in which recovery in the world's largest economy has been gaining traction. A sustained easing of fiscal and monetary policy means that the United States is currently enjoying what former IMF chief economist Kenneth Rogoff has described as "the best recovery money can buy." Business investment has recently joined consumer spending in boosting economic activity and US GDP growth in the third quarter of this year – a 7.2% annualised rate – was the strongest reading since 1984. Most forecasters now expect the recovery to gather momentum going into next year.

There has also been a resumption of growth in Japan, where a surprisingly strong second quarter result this year briefly put that country ahead of the US in the growth stakes and raised hopes of a more sustainable upturn. Elsewhere in East Asia, the region has recovered from the SARs-induced second quarter slowdown (although there is some risk that SARs could re-emerge in the next flu season). In China, for example, third quarter GDP growth was up by more than 9% over the same period last year, putting China on track to exceed this year's official growth target of 7% by a comfortable margin. The current pace of Chinese growth is unlikely to be sustained into next year, but stronger world growth will be good news for the region's export-oriented economies.

Until now the euro-area has remained a global weak spot, with several economies struggling to deal with the fiscal strictures of the stability and growth pact and Europe's largest economy, Germany, unlikely to grow at all this year. Still, there are now signs of improving business confidence, suggesting a better year ahead.

Taken overall, therefore, the normal mechanics of a cyclical upswing – the self-reinforcing effects of stronger growth that economists characterise as accelerator and multiplier effects – should see the current pick-up in activity continue into next year.

Economists are well-advised to be cautious when making such forecasts. Past experience has repeatedly shown that, in the words of Nobel physicist Nils Bohr, "prediction is very difficult, especially about the future." So what might go wrong?

At present, the largest risk to the outlook is the global economy's over-reliance on the United States as its engine of growth and the resulting economic imbalances. In particular, the US current account deficit is now at a record level, requiring well over US$1b of financing every day. Indeed, the World Bank has estimated that last year the US external deficit swallowed 10% of the rest of the world's savings, up from 5% in 1998.

There is now a fairly broad consensus that the US external position is unsustainable and that a fall in the US dollar beyond that already achieved is required as part of the adjustment process. While an orderly currency adjustment need not unduly disrupt global economic prospects, past experience suggests that exchange rate movements can be susceptible to panics and overshooting. In a worst case scenario, an uncontrolled collapse in the US dollar could produce a "perfect storm" in the form of rising risk premiums, bond and equity market volatility, and growing protectionist pressures. Even if the worst case is comfortably avoided – as it was back in the 1980s, albeit with the United States running a much smaller external deficit – the international distribution of adjusting to a weaker dollar will likely be a cause of policy headaches next year.

A second source of risk is the highly-leveraged balance sheet of the household sector in several of the world's economies. While recent years have seen some restructuring of corporate sector balance sheets in the United States and elsewhere, households – encouraged by low interest rates and rising home values – have continued to ramp up their level of indebtedness. As growth accelerates next year and the world's central banks begin to tighten monetary policy, there is a risk that higher interest rates will produce financial distress for over-extended borrowers.

A third concern relates to the world's emerging markets. Recent history shows that while emerging market crises often have only limited consequences for the broader world economy (Argentina's default in December 2001), they can also trigger full-scale global storms (the financial crises following the July 1997 devaluation of the Thai baht). Financial markets have been extremely bullish on emerging markets this year, with falling risk premiums visible in tighter bond spreads and rising equity prices. There is a danger that this optimism has become excessive. For example, there are signs that the flood of overseas money into Russia is taking on bubble-like characteristics, and there are similar risks of overheating in China, where a combination of rapid credit growth and poor credit allocation mechanisms may be encouraging over- and mal-investment. Finally, political risk in SE Asian markets is also set to rise in 2004, with elections due in the Philippines and Indonesia.

So far we have focused on cyclical developments and the near-term risks to the outlook. But there are also important shifts in the underlying structure of the world economy at work. These include the technological and policy-fuelled process of intensified international economic integration and the accelerating "greying" of the population of the world's advanced economies (as of 2000 one out of five people in Europe is now aged 60 or over, while the ratio in Japan is on its way to 1 in 4). These trends are generating a gradual rebalancing in the economic weight of the global economy away from the advanced economies and towards Asia's emerging markets.

These seismic shifts are apparent in the current focus on the rise of China and concerns about the relocation of large parts of the world's manufacturing industry to a Chinese base. There are also growing fears about the challenge posed to employment security in what was previously viewed as the "non-traded" service sector by the rise of outsourcing to countries like India. If both of these economies continue to successfully manage their integration into the global economy – not a straightforward task –the debate about "hollowing out" looks set to grow more heated next year.

Multilateral institutions such as the world trade organisation (WTO) are intended to provide a global framework within which to manage these sorts of issues. But the shifting global balance of economic power is also having an effect here. The collapse of the WTO ministerial meetings in Cancún on 15 September came as a new grouping of developing countries (the G21 or G23 depending on the count) led by Brazil, China and India felt able to exert their own influence on proceedings. The breakdown in negotiations left the current Doha round of trade negotiations "in need of intensive care" in the words of EU trade commissioner Pascal Lamy, and, following as it did the debacle in Seattle in 1999, has created doubts about the future of the multilateral trading system.

What might this mean for the Australian economy in 2004?

Over the past year Australia has faced headwinds from a weaker external environment and a drought-induced disruption to farm production. Looking ahead, a stronger global economy and recovery from the drought – weather permitting, ABARE expects farm output to stage a sharp bounce-back – should provide powerful tailwinds for economic growth. These should more than offset the forces operating in the opposite direction, including the drag from a stronger Australian dollar and from higher interest rates. Note however that the RBA faces challenges similar to other central banks in managing the transition of monetary policy to a tighter setting in the context of a heavily-indebted household sector.

What of the tectonic changes? Australia's geographic location and particular export mix means that it stands to continue to benefit over the longer term from the rebalancing of global economic weight towards Asia. But the current difficulties with the Doha round and the strains created by the rise of the new Asian trading powers need to be managed to ensure those benefits are realised. In this context, efforts to resurrect the Doha Round next year will be an important determinant of global and Australian prospects in the longer run.

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