Viewpoint

By Stanley Fischer*

It is fashionable for people speaking about the global economy to be worried. I am concerned, but the truth is that the current global situation is reasonably good.

The industrialized economies provide the foundation for global growth. The US economy will probably grow at around 4% this year. The Japanese economy, while it had a bad 2nd quarter, is coming out of its decade-long recession. Even the European economies are growing a little faster than had been expected at the beginning of the year.

The picture is better than that in the developing world. China is having trouble getting growth to come down to 8%. Other Asian economies are growing rapidly, some a little less rapidly than expected, but most of them are doing just fine. That includes India and also Russia.

Indeed, one of the most remarkable episodes in global economic history is taking place in Asia, as over 2 billion people, in India and China, are seeing increases in their standard of living that have never been matched on that scale in all of history. They have been matched only in the recent past, and on a smaller scale, in Japan and Korea and Taiwan. That is the reason why global poverty is decreasing, and that is the reason why the global economy is expanding more rapidly than it did in most of the post WWII period.

We are currently in a period of extraordinary stability in exchange rates and in interest rates. Indeed, many a trader wishes that the world were a little more volatile than it has been in recent months. But not to worry, something will come along to increase volatility.

That's the overall picture. It sounds very good, but it's not as good in the industrialised countries as we expected, say, four months ago. The 2nd quarter was disappointing in the US and in Japan. Why? The main reason is the price of oil. The best estimate of the impact of a $10 increase in the price of oil is that it produces a decline in global growth of around half a percentage point and an increase in global inflation of around half a percentage point. We have had the $10 plus increase in the price of oil and we are seeing a slow-down relative to expectations that is somewhere around 5/10 of a percent.

The oil price is however not excessively high. It is high by the standards that we've come to accept in the 1990's. It is only half in real terms of what it was in 1980. The price of oil is expected now to be in the mid $30 range, $10 above the expected long-term level a year ago. We will adapt to this higher price of oil, and it will gradually stop taking a bite out of growth as we adjust to it.

Next China: There has been a concern that the Chinese economy might have a hard landing. That seems not to be happening. But there will have to be a change in China's growth strategy at some point. Japan and Korea and Taiwan and Malaysia and Thailand all grew by having exports expand at double-digit rates over long periods. Chinese exports are already sizeable, in excess of $400 billion per year. They have been growing at high double-digit rates.

But China is becoming a major factor in the global economy and their exports cannot continue to increase at such high rates. That does not mean that the Chinese economy cannot continue to grow at present rates. China's saving rate is over 40% and countries can grow perfectly well with savings rates of 30%. China can continue to grow by shifting towards domestic demand as the source of demand for their extraordinary growth engine. It is not a perfect engine by any means - but it is nonetheless an extraordinary machine.

Next concern: What about the U.S. deficits, the twin deficits, and the damage they could wreak? The US current account deficit exceeds 5% of GDP and it cannot continue at this rate. Why? Because the arithmetic says that if the US continues to borrow over 5% of GDP a year, and given growth projections, the external debt will rise indefinitely as a percentage of GDP. That can't happen. So something has to change.

The current account deficit has to come down to about 2 ½ -3% of GDP. That will happen when the Asian countries, with whom the US is running a total deficit of over $300 billion decide that they don't want to buy American assets any more, and when the central banks of Asia decide they don't want to finance the American budget deficit.

John Connolly, who was President Nixon's Treasury Secretary used to say 'the dollar is our currency and your problem'. It's a problem for China and a problem for Japan that their currencies will have to appreciate at some point. When that happens, current account deficits will begin to close, with a lag. Will that be disruptive? Mildly. It will probably cause interest rates to rise in the US, and it may lead during the period that the dollar is depreciating to some outflow of funds from the stock market and to a stock market slowdown.

But as you think about all those threats, ask yourself what was the value of the Euro 2 years ago. It was 80c. It's about $1.25 now. It's been $1.30. The Euro moved nearly 50% within two years, and that did not cause any massive disruptions. The global economy's capacity to deal with exchange rate changes, with the development of hedging markets and derivative markets, is much different than it was 25 years ago. And the degree of disruption that would be caused by currency adjustment is much less than people fear or than it may have been a quarter of a century ago.

What about the US fiscal deficit? That *is* a long-term worry of substantial proportions. Assuming the Iowa polls are right and President Bush continues in office, the US budget deficit will be below 4% of GDP this year and will then rise to about 4% for the next 10 years. At the end of those 10 years the US debt to GDP ratio will be 53%. Not a number that would cause any grey hairs in Europe.

It is not desirable that our debt continues to rise. It would be much better if we had a smaller deficit. But these projections do not portray a catastrophe. The really big problems begin around 2015 when healthcare spending, Medicare spending, is expected to increase. We don't have a clear solution for that. But we do have a solution for social security, which can be fixed with reasonable changes in the parameters of the system. Thus the deficit presents a serious threat, but one that is mainly 10 years away.

Finally, we could ask about this decade. We're four years into it and we have had weak economic performance in the industrialized countries. Are we heading for a slow growth decade after the excesses of the 1990's? Arithmetically, because global growth has been slow for the first four years of the decade, growth this decade is likely to be lower in the industrialized countries than it was in the 1990's and 1980's. But the growth rate from 2004 onwards is not likely to be lower than the average of earlier decades.

So where are we? The world is a dangerous place. There are countless risks out there. We have discussed several of them. Quite likely there are other major risks, any of which could cause the next recession. Nonetheless the global economy is doing very nicely - but not superbly - at the moment.

Stanley Fischer is vice chairman of Citigroup and was formerly first deputy managing director of the International Monetary Fund. This is a summary of remarks addressed to The Banker's 2004 Awards Dinner in London on 7 September.