

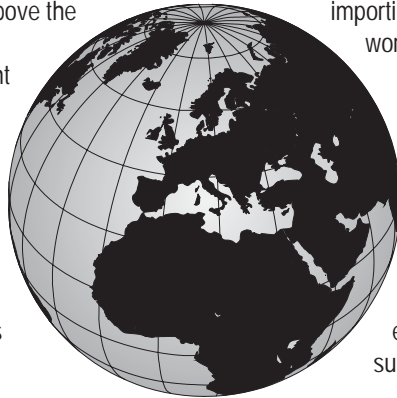
# The International Economy

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World economic growth for 2004 is projected at 5 percent (measured in terms of real gross domestic product [GDP]), compared to growth rates of 2.1 percent in 2002 and 3 percent in 2003. The International Monetary Fund in Washington forecasts world economic growth for 2005 at 4.3 percent,<sup>1</sup> slightly lower than this year but still significantly above the historical average of 3 percent.

The forecast predicts a slight economic slowdown for most world regions (see Table 1), although the Euro area<sup>2</sup> and Japan will grow at a pace close to their respective potential long-term output growth rates. These regions support the U.S. economy in its role as world growth engine.



Like last year, China and India are expected to show robust economic growth in 2005, close to or even above 7 percent. Their resulting demand for energy, particularly Chinese demand for crude oil, has been one key factor explaining its high price. Should the oil price remain at current levels, output growth will be significantly lower for oil-importing economies and the world economy as a whole.

## Europe

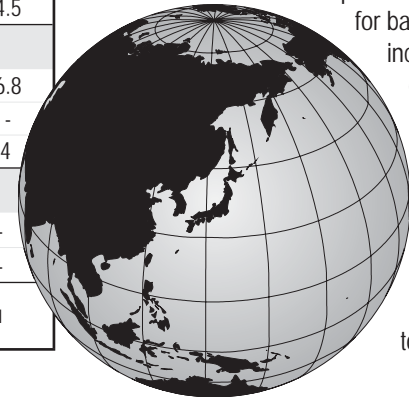
Recovery in Europe has finally gained momentum in 2004 and economic output is expected to rise by 2.2 percent. While this economic upswing was supported by an increase in

domestic demand in countries like Spain and France, in other European countries (such as Germany and Italy), domestic demand is still lackluster. The expected slowdown of world GDP growth will likely hit Germany, by far the biggest economy in Europe, and cause, at best, a stagnation of the current output growth rate. Overall risks appear tilted to the downside, and a high crude oil price will have a significant impact on economic activity. Unemployment is expected to remain relatively high for the entire region. Several factors contribute to this sobering outlook for the Euro area:

- ▶ First, while several Asian countries try to limit a devaluation of the dollar against their currencies, the appreciation of the euro caused significant losses in competitiveness for European exports.
- ▶ Second, rising inflation limits the scope for the European Central Bank to reduce interest rates.
- ▶ Third, the so-called Financial Stability Pact does not allow national governments to use fiscal policy more actively in order to stimulate the economy.

## Asia

Japan enjoyed an unexpectedly strong economic upswing in 2004 with a real GDP growth of 4.4 percent. However, while the economy was growing, the price level was further declining by 0.2 percent. On the plus side were a significant reduction in debt/equity ratios (reduced leverage), a reduction of



nonperforming loans for banks, and increased exports to Asian countries. This should not obscure Japanese dependence on exports to the United

**Table 1**  
Growth Comparisons for Selected Countries

Country	GDP		Inflation Consumer Price Index		Current Account Percent of GDP		Unemployment	
	2004	2005	2004	2005	2004	2005	2004	2005
<b>Europe</b>								
Euro Area	2.2	2.2	2.1	1.9	0.8	0.9	9.0	8.7
France	2.6	2.3	2.4	2.1	-0.6	-0.6	9.4	9.0
Germany	2.0	1.8	1.8	1.3	4.4	4.8	9.7	9.5
Italy	1.4	1.9	2.1	2.0	-1.1	-0.8	8.3	8.2
United Kingdom	3.4	2.5	1.6	1.9	-2.0	-1.9	4.8	4.8
<b>Asia</b>								
China	9.0	7.5	4.3	3.0	2.4	2.8	9.8*	-
India	6.4	6.7	4.7	5.0	0.5	-	-	-
Japan	4.4	2.3	-0.2	-0.1	3.4	3.2	4.7	4.5
South Korea	4.6	4.0	3.8	3.8	3.1	3.3	3.5	3.6
Taiwan	5.6	4.1	1.1	1.5	6.9	6.0	4.7	4.5
<b>North America</b>								
Canada	2.9	3.1	1.9	2.2	2.9	2.4	7.2	6.8
Mexico	4.0	3.2	4.4	4.0	-1.2	-1.5	3.6**	-
United States	4.4	3.0	2.3	3.0	-5.4	-5.1	5.5	5.4
<b>Additional Countries</b>								
Brazil	4.0	3.5	4.0	3.5	1.2	0.4	-	-
Russia	7.3	6.6	10.3	8.9	9.9	7.8	-	-

\*Average second quarter    \*\*Second quarter  
Sources: Center for Econometric Model Research, Indiana University; International Monetary Fund World Economic Outlook, Fall 2004; The Economist Intelligence Unit Country Reports

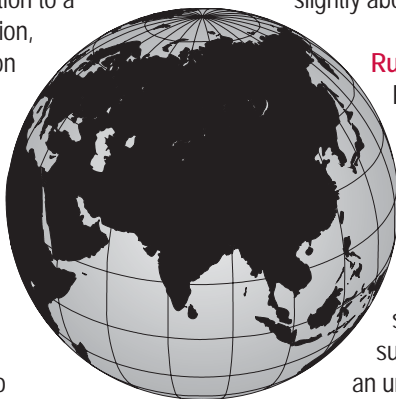
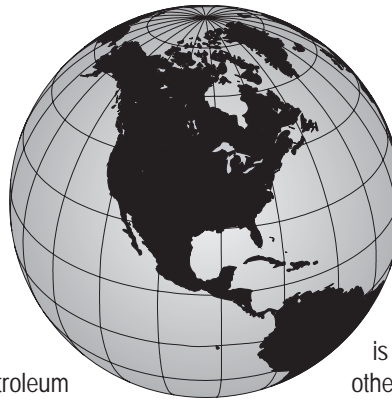
States. The Bank of Japan, its central bank, intervened massively on the foreign exchange market to support the dollar and avoid a stronger appreciation of the yen against the dollar. Currently, the Japanese central bank sits on foreign exchange reserves of almost \$850 billion, and still the yen has significantly appreciated against the dollar. As central bank purchases of the dollar sooner or later will have to come to an end, a further appreciation of the yen is likely and exports to the United States will be harmed. At almost 160 percent of GDP, Japan has by far the largest government debt of all industrial nations. This, in addition to a rapidly aging population, puts a large burden on taxpayers and future generations, which hurts the economic outlook.

The recent recovery of emerging Asian countries was impressive, reaching a growth rate close to 10 percent through mid-2004. Of course, the overall performance of the region is dominated by China and India. Following the example of the Bank of Japan, other central banks heavily intervened in foreign exchange markets in order to avoid an appreciation of their currencies against the U.S. dollar. The Chinese, Taiwanese, South Korean, and Indian central banks sit on historically high levels of foreign exchange reserves—mostly in dollars. As inflation is increasing in this region of the world, this policy will come to a natural end and a future appreciation of their currencies against the dollar seems unavoidable. While the forecast for the region still looks bright, the prospect for China is shadowed by many risks (see section on risks). A sharp slowdown of the Chinese economy or a change of the Chinese exchange rate regime from its current peg of the yuan to the dollar would have significant repercussions in the region.

### North America

The economies of the NAFTA members are increasingly integrated. Strong demand from the United States further increased Mexican

and Canadian exports to the country and contributed to a robust economy in both nations. Unlike Canada, Mexico, as a petroleum exporter, benefits from high crude oil prices. Yet, accelerating inflation is a concern and motivated the central bank to recently tighten monetary policy. Both economies are expected to grow in real terms slightly above 3 percent in 2005.

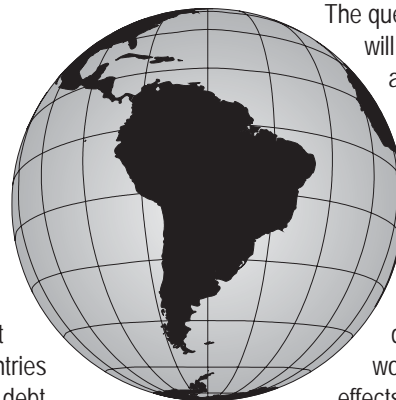


### Russia and East Europe

Russia and most Middle and East European countries are continuing to do well, and the outlook is optimistic into 2005. The common explanation is, of course, the booming crude oil price. Yet, the Russian economy shows signs of severe imbalance, such as accelerating inflation and an unhealthy reliance of the federal budget on revenues from oil exports, while significant structural problems are not addressed.

### South America

Overall, Latin America did very well in 2004 and the prospects for 2005 look rather bright. However, the picture looks more diverse as some oil exporting countries like Mexico, Venezuela, and Columbia gain from the current oil price boom while other countries are hurt. Relatively high public debt remains a concern while external finance conditions will probably deteriorate as U.S. interest rates rise. In addition, accelerating inflation might force the central banks to tighten monetary policy.



in the price of oil reduces world economic growth by 0.3 percent. Continuation of the current oil prices would decrease world GDP growth by roughly 0.7 percent in 2005. Unfortunately, a persistently high oil price for 2005 is likely. One reason is the huge Chinese hunger for oil and other commodities. In 2004 alone, Chinese demand for oil increased by 15 percent, accounting for one third of the growth in global demand. Meanwhile, oil production has almost no unused capacities and any increase in output in 2005 will be very moderate. As the exploration of new oil fields takes several years, no easy solution is on the agenda for the coming year.

A second risk for the world economy is the effect of policies designed to slow Chinese economic growth to sustainable levels, such as increased interest rates and other lending restrictions for banks. A hard landing of the Chinese economy would have significantly harmful effects, particularly for other Asian countries. On the other hand, if successful, these policies would help cool down the world oil price.

The huge U.S. current account deficit, now close to \$600 billion, is worth mentioning.

The question is not if the deficit will decline, but rather when and how fast. The most likely scenario is a further depreciation of the dollar against the currencies of major U.S. trading partners and a correction of the deficit. Yet, a rapid depreciation of the dollar would have devastating effects, not so much directly for the United States, but rather indirectly—by damaging the economies of our major trading partners such as China, Japan, Canada, Mexico, and Europe. ◀

### Notes

1. International Monetary Fund, *World Economic Outlook: The Global Demographic Transition* (September 2004). Available from: [www.imf.org/external/pubs/ft/weo/2004/02/index.htm](http://www.imf.org/external/pubs/ft/weo/2004/02/index.htm).
2. The Euro area includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Holland, Portugal, and Spain.