

The International Economy

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The economic growth around the world looks to remain strong in 2008 despite the “financial turmoil” that we have been experiencing in the United States and, to some extent, in Europe since this summer. The International Monetary Fund (IMF) anticipates world economic growth to reach 4.8 percent in 2008, continuing a remarkable six consecutive years of strong growth for all countries around the world. This significant growth is mostly due to the dynamic nature of the emerging economies, which are growing at 8 percent to 12 percent per year. For the first time, China is the largest contributor to the world growth figures, and combined, China, India, and Russia represent more than half of global growth. However, it is important to emphasize the potential risks to this positive outlook on growth: (1) oil prices are high; (2) there are still some residual financial problems and we are uncertain when, or how, they will occur; and (3) there is risk associated with inflation, particularly in the emerging economies (see **Table 1**).

Europe

After five consecutive quarters of vigorous growth, the economic performance in the Euro area is projected at 2.5 percent for 2007 and an even lower 2.1 percent for 2008. The European Union growth is predicted to be 3 percent in 2007 and 2.5 percent in 2008. This expected deceleration of growth can be explained by the tightening of global credit conditions, the tighter availability of bank credit due to the U.S. housing difficulties, and high commodity prices—particularly high oil prices.

Ongoing unrest in global financial markets has increased the risk associated with the short-term outlook since this summer. Many

European banks are exposed to the U.S. mortgage market, causing a crisis of confidence throughout European interbank markets. (The European Central Bank and the Bank of England have been required to safeguard these markets, but with market participants unable to identify their exposure to losses, there has been a generalized loss of investor confidence in Europe.) The impact of the crisis on the real economy is still unfolding, and if the financial turmoil persists, the risks of a significant negative impact on business and consumer confidence cannot be ignored.

The Euro currency appears to be in line with Europe’s sound economic

fundamentals, but countries such as France, Portugal, and Spain, whose export prospects lack a sufficient cushion in competitiveness, will likely undergo economic weakening from the strength of the Euro currency. This weakening could undermine their confidence in the European Central Bank’s “one-size-fits-all” policy as depreciation of the Euro currency becomes more and more tempting to short-sighted politicians.

Asia

The outlook for Asia is positive overall. Japan, the world’s second largest economy, is continuing to perform well and is expected to

Table 1
International Economic Forecasts

Geographic Area	Percent Change in GDP		Inflation Rate*		Current Account** (Percent of GDP)	
	2007	2008	2007	2008	2007	2008
Emerging Asia***	9.2	8.3	4.9	4.2	6.6	6.5
Advanced Economies****	2.5	2.2	2.1	2	-1.3	-1.4
China	11.5	10.0	4.5	3.9	11.7	12.2
India	8.9	8.4	6.2	4.4	-2.1	-2.6
Africa	5.7	6.5	6.6	6.0	n/a	0.6
Russia	7.0	6.5	8.1	7.5	5.9	3.3
Venezuela	8.0	6.0	18.0	19.0	7.8	4.1
Argentina	7.5	5.5	9.5	12.6	0.9	0.4
South Korea	4.8	4.6	2.6	2.7	0.1	-0.4
Brazil	4.4	4.0	3.6	3.9	0.8	0.3
Taiwan	4.1	3.8	1.2	1.5	6.8	7.1
Mexico	2.9	3.0	3.9	4.2	-0.7	-1.1
United Kingdom	3.1	2.3	2.4	2.0	-3.5	-3.6
Canada	2.5	2.3	2.2	1.9	1.8	1.2
Euro Area	2.5	2.1	2.0	2.0	-0.2	-0.4
Germany	2.4	2.0	2.1	1.8	5.4	5.1
France	1.9	2.0	1.6	1.8	-1.6	-1.8
United States	1.9	1.9	2.7	2.3	-5.7	-5.5
Japan	2.0	1.7	n/a	0.5	4.5	4.3
Italy	1.7	1.3	1.9	1.9	-2.3	-2.2

*Consumer Price Index

**The IMF definition of current account is “the record of all transactions in the balance of payments covering the exports and imports of goods and services, payments of income, and current transfers between residents of a country and nonresidents.”

***Emerging Asia includes developing Asia, the newly industrialized Asian economies, and Mongolia.

****Advanced Economies include the United States, the Euro area, Japan, United Kingdom, Canada, Korea, Australia, Taiwan Province of China, Sweden, Switzerland, Hong-Kong, Denmark, Norway, Israel, Singapore, New Zealand, Cyprus, and Iceland.

Source: IMF World Economic Outlook

grow at 2 percent in 2007 and 1.7 percent in 2008. Last year, consumer prices started rising—a welcomed development following seven years of deflation that crippled economic growth. However, mild deflation made its reappearance this year, and the slowdown in the U.S. housing market is creating a negative risk to Japan's economic growth, making it inadvisable for the Bank of Japan to increase interest rates and strengthen the yen.

China is still doing exceptionally well and is projected to grow at 11.5 percent in 2007 and 10 percent in 2008. Due to its export-oriented economy, China can be affected by an economic slowdown in its key markets. The effect of a potential global slowdown on Chinese growth could actually be welcomed by policymakers who are concerned about the overall rapid growth, risk of high inflation, and excessive trade surplus of the Chinese economy. Moreover, the Chinese trade surplus is causing international tensions and could lead to future macroeconomic concerns for China. The focus should continue to be placed on this external imbalance and an appreciation of the real exchange rate for the renminbi.

India's economic performance is very satisfactory and the country's economy is expected to grow at 8.4 percent next year.

If China and India are excluded, the other economies in developing Asia are expected to grow at a more modest, but still very strong, pace of 5.7 percent in 2007 and 5.6 percent in 2008. To date, the volatility in the global financial market has had a limited impact on the Asian emerging markets. However, in these export-led economies, the possibility for further global financial market turbulence constitutes a significant downside concern. Driven by the region's large current account surplus, the foreign exchange inflows have been very strong. Despite the initial successful management of those inflows in 2007, additional policy responses to slow down the

surge in lending and investment growth will be needed to further boost their consumers' purchasing power and sustain growth while minimizing the chance of overheating their economies.

Russia

The Russian economy, showing its resilience despite the turbulence in the global credit market, is growing strongly at 7 percent in 2007 and 6.5 percent is forecasted for 2008. High oil prices are certainly helping, but credit should also be given to the economic policies that in 2007 delivered the lowest annual inflation rate since the breakup of the Soviet Union.

Latin America

Latin America is expected to see output growth of 5 percent in 2007 and 4.3 percent in 2008. Despite policy reforms in this region, the economic performance has been disappointing and remains well behind that of Asia. Furthermore, a downturn in the United States is likely to have a negative effect on overall exports from Latin America. In Mexico and Central America, where exports to the United States have been critical, the possibility of the U.S. economy cooling off will present a large problem for growth. If the slowdown occurs in the United States and spills over to China, it will result in declining commodity prices. Also, a deceleration in the export of commodities from South America could set back the recent growth of countries such as Argentina or Venezuela. More importantly, populism has been on the rise; therefore, it is pressing for several economies in the region to adopt policies that are more supportive of sustained long-term growth, as some countries in this region have been increasing the vulnerability of their economies to more shocks.

The Risks

The global economy is facing a period of uncertainty and a number of risks

threaten to cool down the global economy in 2008. The turmoil in the financial markets has the potential to affect growth worldwide, not just in the United States. This effect could be moderate to quite substantial, and temporary to persistent. Regardless of its magnitude, weaker growth in the United States will have spillover effects on trade and weaken the economies of its trading partners. Moreover, in our globalized economy, many countries could be affected by the developments in the global financial system through financial contagion. The contagion caused by the U.S. subprime mortgage crisis, which resulted in a global credit crunch, has further exposed this danger.

Also, there are still global imbalances: twin U.S. budget and current account deficits and the accumulation of huge foreign currency reserves by Asian central banks remain. Over much of the past decade, the United States has failed to increase its savings rate or reduce imports. No serious efforts have been made to reduce the budget deficit and the United States remains dependent on foreign lenders—Asian central banks in particular. Such weaknesses not only threaten to hinder overall U.S. competitiveness, but they represent a risk to the global economy. On the other hand, in 2007 China began contributing to the solution by allowing its currency to appreciate against the dollar. This should relieve some of the pressure created by China's immense exporting growth, but more flexibility in the exchange rate is needed to reduce this large and unpredictable risk on the global economy.

It is clear that rising food and oil prices are secondary risks for the world economy as they will be further inflated by the disruption in the global financial market. Rising oil and food prices will have negative effects on consumption spending and continue to increase worries about inflation worldwide. ■