As the pace of global economic expansion slackens, apprehension over future trends has deepened. But, while a slowdown in the pace of growth is inevitable over the next year, fears of major recession are unjustified, argues **David Kern**.

2005: Slowdown or recession?

Executive summary

- A significant slowdown in growth in the second quarter of 2004 was marked in US and Asian countries such as Japan and China.
- An upsurge in oil prices caused by events such as the war in Iraq led to unsettled stock and bond markets but prices should fall by mid-2005.
- Despite the rise in oil prices, consumer inflation will only rise slightly next year.
- The slowdown in the pace of expansion next year is expected to be significant but tolerable.
- Oil prices are expected to come down gradually, interest rates will rise moderately and global pressures should ease.

Global economic growth slowed significantly in the second quarter of 2004, and preliminary data for the third quarter is disquieting. A reduction in the pace of expansion was marked in the US, which consistently led the current economic upturn, and in a few other important contributors to world growth, notably Japan and China.

The recent slowdown contrasts sharply with the unusually strong recovery experienced early in 2004, which generated excessive optimism and undue exuberance in the financial markets. Hopes that activity could be sustained at the raging pace seen early in 2004 were bound to be disappointed. Thus, when growth in key economies stalled, the reaction was despondency, coupled with fears that a new recession may be imminent. However, both the initial over-confidence and the subsequent gloom were unwarranted. Higher interest rates, oil prices, and fears over terrorism will limit growth. A new recession is most unlikely but global growth will slow markedly over the next year. Many problems and imbalances persist and if not resolved they will dampen growth in the medium term.

UPSURGE IN OIL PRICES. An unsettling development this year was an upsurge in oil prices to heights not seen for two decades (See *Positive energy*, page 11, July/August, *The Treasurer*). Since the early 1970s, most world recessions were preceded by sharp oil price increases, so it is no surprise that recent developments in the market have unsettled stock and bond markets.

Table 1. Global inflation from 2001-2005
Consumer prices (% change on previous year)

	2002	2003	2004	2004	2005
US	2.8%	1.6%	2.3%	2.7%	2.4%
Japan	-0.7%	-1.0%	-0.3%	-0.1%	0.2%
Euro zone	2.4%	2.3%	2.1%	2.1%	1.8%
Germany	2.0%	1.4%	1.1%	1.6%	1.3%
France	1.6%	2.0%	2.1%	2.2%	1.7%
The UK	1.2%	1.3%	1.4%	1.6%	1.8%
China	0.7%	-0.8%	1.2%	4.5%	4.1%
India	3.8%	4.3%	3.8%	3.6%	3.8%

Some of the reasons for higher oil prices were geo-political – Iraq, Venezuela, the Yukos situation in Russia, and above all, fears of a terrorist attack on Saudi oil facilities. But there were also fundamental economic factors underpinning the oil upsurge, particularly above-trend output growth, strong demand for energy in many regions (e.g. China, India and the US), and bottlenecks in US refining capacity. At their August 2004 peak, oil prices were more than 40% higher than the year previously.

Concern over the potential adverse implications of this upsurge was accentuated by the sharp rise in the price of other commodities. Metal prices, for example, showed year-on-year increases of almost 35% in August.

High oil and commodity prices will lower growth and worsen inflation but the damaging effects can be exaggerated. In real terms (i.e. after adjusting for inflation), prices are well below previous peaks, and oil and commodities in general account for a much lower share of economic activity than in previous decades.

However, in spite of rising oil prices, general consumer price inflation in the main economies is set to rise only slightly next year (see *Table 1*), and the policy response of the major central banks is likely to be limited to modest increases in official interest rates.

Oil prices are unlikely to fall significantly, but higher Organisation of the Petroleum Exporting Countries output and slowing world demand will bring them down gradually. The price of Brent crude (currently some US$40 per barrel and below the recent peak of US$45) should fall to US$33 per barrel by mid-2005.

STRUCTURAL IMBALANCES. The US, the main economic global driver, suffers from deep-seated imbalances, with inadequate savings, excessive debt and huge budgetary and external deficits. Since the American economy is highly productive, dynamic and competitive, these problems have not halted US growth.

Aggressive interest cuts by the Fed, coupled with massive fiscal expansion, have supported US economy in recent years and contained downward pressures. But, while helping to sustain US growth, these policies have made US deficit and debt problems worse.

Other main global players have adopted strategies that have exacerbated the imbalances further. China and Japan have run large export surpluses with the US to encourage domestic growth and employment and amassed huge forex reserves to keep their currencies artificially weak against the US dollar.

Figure 1. External imbalances: Current account deficits and surpluses, 2004 (estimates in US$)

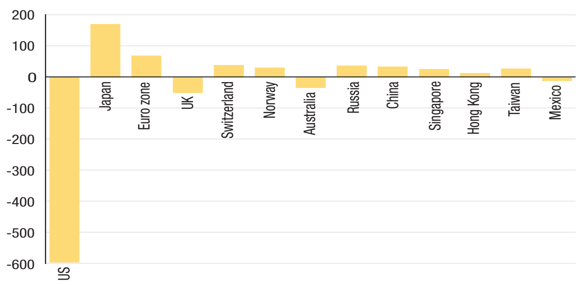

Table 2. Global economic growth from 2001-2005
GDP, (% change on previous year)

	2002	2003	2004	2004	2005
US	0.8%	1.9%	3.0%	4.5%	3.5%
Japan	0.4%	-0.3%	2.5%	4.0%	2.0%
Euro zone	1.6%	0.9%	0.5%	1.7%	2.0%
Germany	0.8%	0.2%	-0.1%	1.5%	1.7%
France	2.1%	1.1%	0.5%	2.1%	2.1%
The UK	2.3%	1.8%	2.2%	3.4%	2.6%
China	7.5%	8.0%	9.1%	8.8%	7.6%
India	4.0%	4.7%	7.4%	7.1%	6.7%

The euro zone has aggravated the problem by keeping domestic demand unduly weak and relying unduly on exports. *Figure 1* contrasts the massive US deficit with the large surpluses of Japan, the euro zone, and a few other economies in Asia and Europe.

MIDDLING PROSPECTS. The expected slowdown in the pace of expansion next year is significant but tolerable (see *Table 2*). US growth is set to slip from 4.5% in 2004 to 3.5% in 2005, slightly lower than expected a few months ago, but still satisfactory given the need for major policy adjustments.

Japan's surprising recovery, with growth of 4% this year, may slow to 2% in 2005. This is still an acceptable pace given the huge unresolved problems in the banking and corporate sectors.

In the euro zone, growth will remain disappointing but stable at around 2% in 2005. Growth in the UK is also set to slow down from 3.4% in 2004 to 2.6% in 2005, but Britain's performance remains strong and compares favourably with the rest of the euro zone.

Growth in China is set to decelerate further in response to tough restrictive policies aimed at cooling an excessive boom. But, if the Chinese authorities are flexible in enforcing the policy squeeze in a flexible manner, a hard landing will be avoided.

Oil prices are likely to come down gradually, and with interest rates rising moderately, global pressures should ease. If confidence weakens in reaction to the huge US external deficit, there is a distinct risk that the dollar could fall sharply, and this could pose a serious global threat.

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