



Bush versus Kerry: The Economy in the Balance? (Part II)

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Subject: What kind of international economic context will a President Bush or a President Kerry face? What does it imply for either candidate's future potential room for manoeuvre?

Summary: At first glance the international economic scenario does appear rosier than ever. Synchronized world growth this year has produced the fastest global growth rate in a generation. Nevertheless, a number of lingering weaknesses and new threats will reduce the responsible room for manoeuvre for the next US president, regardless of who actually occupies the White House in 2005. The list of international economic challenges and threats include high oil prices, flimsy foundations for recovery or continued growth in most of the major economic zones, deepening global macroeconomic imbalances, the spectre of a dollar crisis and the threat of renewed protectionist pressures. Neither Bush nor Kerry would have it easy

Analysis: Despite the clear differences between the economic visions and policy orientations of Bush and Kerry, either candidate will likely face a difficult economic scenario. This might come as a surprise to the many who believe the US is currently experiencing a strong economic recovery. Nevertheless, the economy now finds itself in a paradoxical situation. Currently the world economy is experiencing growth of around 5%, one of the fastest collective paces in over a generation. What is more, nearly all of the major economic zones of the world are growing together in a synchronous fashion, something which has not occurred in recent memory. The US and China –growing at annual rates of 5% and 9%, respectively– along with some other emerging markets, are leading the charge, but even Japan, Europe and Latin America are showing signs of recovery. At first glance, this would normally be very good news. However, there are a number of challenges facing the world economy and several vulnerabilities which should be haunting even the most optimistic (see Fred Bergsten, 'The Risks Ahead for the World Economy', *The Economist*, 11 September 2004).

Oil Prices

First, there is the high price of oil. Oil prices have risen nearly two-thirds during the current year alone, reaching levels above US\$55 per barrel for West Texas International and above US\$52 per barrel for Brent crude. Although both benchmarks have given back about US\$5 from their peaks during recent days, the short-term outlook is not rosy. The reasons for this year's price increase are manifold and well-known, ranging from the uncertainties surrounding many of the world's oil-producing regions (including the Middle

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East, Russia, Norway, Venezuela and Nigeria) to hurricane disruption in the Gulf of Mexico and the Caribbean.

Such typically passing factors have all converged during a year of historical high demand and rapid oil consumption growth, a product of the current synchronized global growth boom. Furthermore, there has been a particular dearth of both upstream and downstream investment in recent years on the part of the energy industry. While this trend seems to be reversing, there is no guarantee that enough new pumping and refinery capacity will come on line quickly enough to avoid significant damage to world growth. After all, the world's spare oil production capacity (down to just over one million barrels a day) is now at an all-time low, approaching a mere 1% of total output. Even at the height of the oil shock in the 1970s, the world system enjoyed about 3% spare capacity. But even if oil prices do subside from today's high levels, it is unlikely that OPEC countries will allow prices to fall as low as the traditional US\$25 target. With the dollar weakening, OPEC countries – already facing tougher budget and debt scenarios and rising domestic demands for social spending– are now suffering from declining dollar purchasing power. If and when output capacity does increase again, OPEC is likely to target the world price at somewhere above US\$30. Therefore, the most likely eventual equilibrium would imply somewhat higher oil prices and slower growth than traditionally expected, at least for some time.

The Fragile World Recovery

Second, the world recovery remains fragile. Given lacklustre employment creation, weak personal income gains (still below consumption increases), low personal savings rates and high and rising household debt levels, the underpinnings of the US recovery remain weak. China is already facing the beginning of a slowdown and still runs the risk of a hard landing. The recoveries in Japan, Europe and Latin America remain fragile and export-led, while domestic demand lags dangerously behind, making these regions hostages to both currency appreciation and growth slowdown in the US and China. All of these regional fragilities could feed one other, and each could deteriorate further under the weight of high oil prices.

Dangerous Global Imbalances

Third, the deepening of global macroeconomic imbalances has made the world economy more vulnerable to either a significant growth slowdown or a dollar crisis –or both–. The US current account deficit is now running at an annual level of US\$600 billion, equivalent to nearly 6% of GDP and accounting for nearly two-thirds of the world's current account surpluses. Furthermore, while the 2001 recession did nothing to reverse the deficit trend, the US current account deficit has moved from being primarily generated and financed by the private sector (suggesting its sustainability) to being generated increasingly by US public deficits and financed almost exclusively by public actors such as Asian central banks, particularly China's (bringing into question its sustainability). Typically, this situation would suggest that the dollar must fall, either sooner (in a more gradual fashion) or later (in a more abrupt and destabilizing fashion). But given that private investors have already begun to shy away from continuing to finance the US's external deficit, some analysts have begun to point to an alternative explanation as to why the US current account deficit can continue to grow and still be sustainable for another 20 years or so (see, for example, Michael P. Dooley, David Folkerts-Landau and Peter Garber, 'An Essay on the Revised Bretton Woods System', NBER Working Paper nr. w9971, September 2003, along with other more recent NBER papers by the same authors).

Under the so-called Bretton Woods II informal arrangement, China's fixed exchange rate for the yuan (CNY8.28/US\$1.00) –probably undervalued– allows China to continue to support an export-led growth model which is fed by excess domestic demand in the US. The result is a growing Chinese trade surplus with the US and a growing US current account deficit. On the other hand, this arrangement allows China to continue growing at rapid rates, absorb excess labour from the countryside into booming industrial export sectors which, while exporting to the US, import inputs from China's neighbours, including Japan, allowing China to pull the rest of Asia's export-led growth models with it. Because the Chinese regime faces the imperative of maintaining political stability and economic growth, it has an enormous incentive to maintain an undervalued fixed exchange rate for the yuan against the dollar. This requires it to accumulate dollar reserves and to use them to purchase US treasury bonds. This, in turn –together with similar behaviour by the Japanese and other Asians–, allows the US to finance its growing budget and current account deficits in general and in particular the growing imports from Asia and the increasing military costs associated with the Iraq intervention in particular.

Proponents of this *de facto* Bretton Woods II arrangement argue that it allows for both Asia to grow rapidly and for the US to continue serving as the world's growth engine sustainably into the future, despite growing internal and external imbalances that would normally presage a significant negative adjustment even for an advanced economy. Their conclusion is that not only should a growing US current account deficit NOT be viewed with alarm, but that it should actually be welcomed as a new paradigm allowing for developing Asia to emerge from the periphery into the core of the world economy.

However, this is a very risky proposition. First, not everyone will be happy with this arrangement. As the US external deficit continues rising, the natural adjustment process, unable to occur *vis-à-vis* Asia, will take place increasingly with respect to Europe, pushing up the euro against the dollar. Dollar depreciation will therefore place increasing pressure on Europe's industrial export base which, despite even the euro's recent appreciation, continues to be the pillar of Europe's fragile recovery. Secondly, while Europe might be the most disgruntled party, there are other weak links in the chain. Developing countries, particularly in Asia, will be increasingly exposed to a significant capital loss on their growing dollar reserves should this *de facto* system of financial and trade flows break down, provoking a strong depreciation of the dollar. Each country accumulating dollars will face a growing incentive to free-ride and bolt from the system before it collapses, diversifying its reserves away from the dollar and no longer contributing to the financing of the US external deficit. Given that the system is not built on a formal set of accepted mutual obligations, it will always be inherently unstable. Bretton Woods I at least had strong international economic governance underpinnings. Bretton Woods II does not.

Third, after Asia, the next largest financier of US deficits is the bloc of oil producing countries, including OPEC. These countries, too, will experience growing incentives to diversify their holdings, and perhaps will even be considering finally shifting the defining currency of their oil industries from the dollar to the euro. As many of the major energy producers are highly and increasingly integrated with the European economy in terms of trade, further adjustment forced onto the euro will imply ever declining international purchasing power for oil exporters. To the extent that Bretton Woods II (essentially a US-Asian affair) continues, the pressure on oil exporters to consider changes will increase.

Finally, while this arrangement might appear to be of extreme convenience to both the US and Asia, particularly China, it is not clear that it is a symmetrical symbiotic relationship. While it allows the US to continue to go further into debt (both domestically and internationally), and allows China to continue to grow rapidly and absorb excess labour, ultimately China holds the cards. If the US does not take the lead in reducing its deficits, then China will have the power to decide exactly when it no longer needs to accumulate dollar reserves. While this might be an economic version of the Cold War's 'peaceful coexistence', unlike in the *détente* of the 1970s, in this case the US would seem to be willingly assuming the role of the more vulnerable partner. In the final analysis, although the newly-touted Bretton Woods II may have provided some margin for the US to continue with unsustainable behaviour, it does not herald a new paradigm in which deficits do not matter and the dollar cannot crash. Just remember 'the end of history' and 'the end of the business cycle' claims of the 1990s.

The Threat of Protectionism

Fourth, and finally, another threat to the world economy is the fragile state of international trade negotiations and the emergence of protectionist pressures. As the dollar remains overvalued against the Asian currencies, and as the euro becomes increasingly overvalued against the dollar, protectionist sentiment could easily increase in the US and Europe, the world's two most important trading blocs and the world's key trade negotiators. Without astute leadership by, and credible consensus between, the US and Europe, the WTO's Doha Round of trade negotiations have almost no chance of success. Furthermore, in the face of rising protectionist sentiment, even the regional trade accords being pushed by the US and the EU will likely flounder. A breakdown of current negotiations might be absorbed by the international economy, but an outbreak of new protectionism, given the current fragile and unbalanced nature of the world economy, could be disastrous.

Conclusion: This difficult international economic scenario will make both domestic and international economic policy for the next president a supreme challenge. Under almost any scenario, it will become increasingly difficult and dangerous to keep growth in the US above 3%. Any attempt to use policy to keep the recovery strong in the US is likely only to postpone a global crisis and feed its proportions. Any attempt to use policy to ultimately head off a crisis implies accepting, sooner rather than later, even slower growth for an extended period of time, possibly aggravating the employment situation in the US and feeding protectionist sentiment. While either Bush or Kerry is likely to face an increasing reticence from both Congress and the Federal Reserve to continue accommodating a policy designed to extend the recovery at the current high growth rates, each candidate would probably be inclined to handle this situation in different ways. This allows us to explore in Part III what would be the likely extreme scenarios under a Bush or Kerry presidency.