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ISSUES BRIEF

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# THE INTERNATIONAL ECONOMY IN 2003: MANAGING ECONOMIC IMBALANCES IN AN INTEGRATED WORLD

## EXECUTIVE SUMMARY

*This Issues Brief suggests that a key theme over the past year has been the management of external imbalances in a world economy that is not only increasingly integrated but which is simultaneously undergoing a sustained geographic shift in the distribution of economic weight towards Asia. Using this theme as an organising principle, it reviews several major economic developments including US current account adjustment, international exchange rate adjustment in response to that process, growing Sino-US trade tensions, the increasing focus on international outsourcing and the stresses facing the current multilateral trading round. The Brief concludes by arguing that many of these same themes will influence international economic prospects over the coming year.*

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**THE INTERNATIONAL ECONOMY IN 2003: MANAGING ECONOMIC IMBALANCES IN AN INTEGRATED WORLD****Managing economic imbalances in an integrated world**

A key economic theme over the past year has been the management of external imbalances in a world economy that is not only increasingly integrated but which is simultaneously undergoing a sustained geographic shift in the distribution of economic weight towards Asia.<sup>1</sup> This theme links several of the major economic stories of 2003, including the adjustment strains created by the re-emergence of large current account deficits in the US, the debate over East Asia's (lack of) participation in global exchange rate adjustment in response to those deficits, the growth of Sino-US trade tensions, the increasing focus on the implications of international outsourcing and the stresses facing the current multilateral trading round. Moreover, the same theme looks set to be a major driver of international economic relations in 2004.

**The imbalances at the heart of the global economy**

Developments in the US have dominated the international economy in recent years, as the world's largest economy has been the main driving force behind global growth. On one count it has accounted for almost 60% of the cumulative rise in world output since 1995.<sup>2</sup> Importantly, this relative economic preponderance has co-existed with the presence of several major economic imbalances, including a big private sector financial deficit and lately a sharp swing into fiscal deficit. Indeed, government and private sector financial balances at the start of the economic upturn in 2003 were in

worse shape than in seven of the eight previous US economic recoveries.<sup>3</sup>

The recent move into fiscal deficit has been particularly pronounced, with the general government balance moving from a surplus equivalent to 1.2% of GDP in 2000 to a deficit of 3.8% of GDP in 2002. The IMF thinks that the red ink will continue to comfortably exceed 3% of GDP until 2007.<sup>4</sup> The prospect of continued fiscal deficits for much of the current decade has prompted some concern since demographic pressures – specifically the retirement of the so-called “baby-boom” generation (that cohort of the population born between 1946 and 1964) – mean that the budget is likely to face increasing spending demands over the medium term. A recent study by the US congressional budget office (CBO) looking at scenarios for federal expenditure and revenue through until 2050 identifies rising health costs and an ageing population as a source of growing financial strain for social security and programs such as Medicare and Medicaid. The CBO report concludes that, in the absence of historically unprecedented tax increases, current US spending policies will “probably be financially unsustainable” in the medium-term.<sup>5</sup>

These substantial internal imbalances have also produced an external counterpart in the form of the re-emergence of record current account deficits. After turning in a – then record – deficit of US\$480.9b in 2002, the current account shortfall in the first three quarters of 2003 reached US\$413b. At these levels the deficit is running at an annual rate of around US\$½ trillion, or about 5% of US GDP.<sup>6</sup>

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<sup>1</sup> Some of these structural developments are discussed in a recent Lowy Institute working paper Thirlwell (2003a)

<sup>2</sup> Minton-Beddoes (2003)

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<sup>3</sup> Llewellyn (2003)

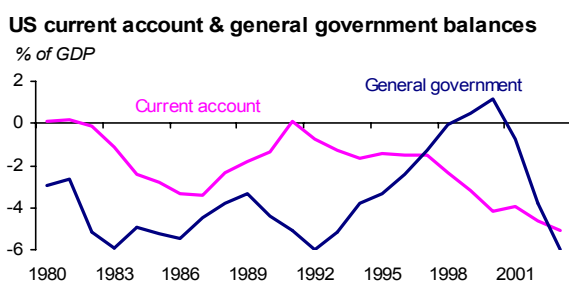
<sup>4</sup> International Monetary Fund (2003)

<sup>5</sup> Congressional Budget Office (2003)

<sup>6</sup> By way of comparison, the current account deficit in the 1980s twin deficits era peaked at less than US\$161b in 1987.

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The combination of large fiscal and external deficits has produced a return to the “twin deficits” era of the 1980s. The leakage from the fiscal deficit into the current account gap is unlikely to be one-for-one. But empirical estimates suggest that typically about one-third of the decline in US national saving represented by a budgetary shortfall is offset by capital inflows from abroad and hence by a larger current account deficit.<sup>7</sup>

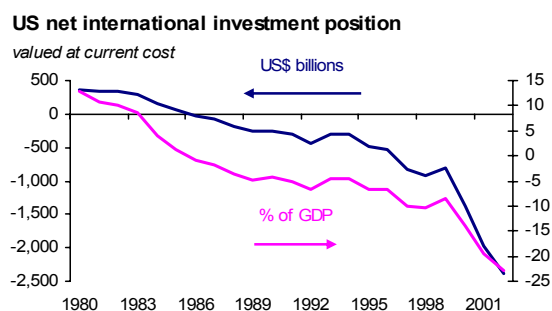


Source: International Monetary Fund (2003)

Financing the present current account deficit requires the US to attract capital inflows approaching US\$2b each working day, implying a dramatic increase in external liabilities over time. Indeed, the move into external deficit has already produced a big swing in the country’s net international investment position. By the end of 2002, the value of foreign investments in the US already exceeded the value of US investments abroad by US\$2,387b, leaving the US with net international liabilities equivalent to more than 20% of GDP. Moreover, on current trends the current account deficit is set to expand further through 2004, requiring even greater amounts of external financing and implying a greater decline in the net investment position.

To date, the US has been able to attract the funding required to cover these external deficits in a

relatively comfortable manner. But it is notable that the composition of external financing has started to shift, so while in 1999-2000 about 90% of the current account gap was covered by FDI inflows, by the first half of 2003 about half was covered by central bank and private purchases of US government securities.<sup>8</sup> And as 2003 drew to a close, the relative importance of central bank purchases of US assets continued to increase, with East Asian institutions being particularly big buyers. As a result, both the future path of the US dollar and the pace of external adjustment are becoming (at least in part) a function of East Asian financial policy.



Source: Bureau of Economic Analysis

At the same time, some warning signs have started to appear suggesting that the external financing constraint may finally be starting to bite. Thus there was a sudden sharp decline in net portfolio inflows into the US in September 2003, with net inflows plunging to their lowest level since the LTCM crisis in 1998. Indeed, the fall represented a steeper slide than the one recorded after the September 11<sup>th</sup> terrorist attacks.<sup>9</sup> The scale of this drop prompted fears that overseas investors had finally had their fill of US assets, although net inflows staged a modest recovery in the following month, rising by US\$27.6b in October.

<sup>7</sup> Rubin, Orszag and Sinai (2004)

<sup>8</sup> Organisation for Economic Cooperation and Development (2003)

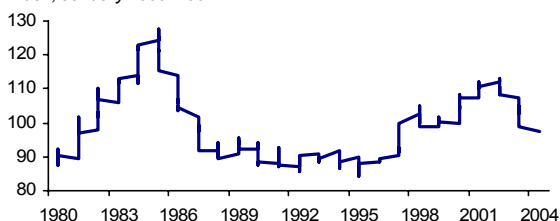
<sup>9</sup> McCaughrin (2003)

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A review of the historical experience with current account adjustments in industrialised countries since 1980 suggests that the present level of the US current account deficit – about 5% of GDP – is the point at which external adjustment typically gets under way, usually in the form of a combination of real exchange rate depreciation and slower growth.<sup>10</sup> The first part of this adjustment process has already begun, with the US real exchange rate depreciating since early 2002. But US economic growth is currently showing signs of *accelerating*, rather than declining, and most economic forecasts call for stronger US and global growth in 2004.

**US real broad effective exchange rate**

Index, January 2000=100



Source: US Federal Reserve

Could this year witness a shift to a more painful external adjustment process? Optimists such as US Fed Chairman Alan Greenspan argue that any transition to a smaller deficit is likely to be relatively orderly. At a speech given in November last year he argued that “spreading globalization has fostered a degree of international flexibility that has raised the probability of a benign resolution to the U.S. current account imbalance.”<sup>11</sup> In his view, increasing international financial integration has boosted the willingness of investors to hold overseas assets, lowering the degree of so-called ‘home bias’ in their portfolio selection process. This greater appetite for

international paper makes it possible for creditworthy countries to finance larger external deficits than was the case in the past, implying that history may be a poor guide to current developments. Greenspan also suggested that growing economic flexibility – both in terms of the US domestic economy and in terms of the international economy – would tend to encourage a smoother external adjustment process.

There is almost certainly something in this description of the benefits of a more integrated global economy. But as several economists have pointed out, the level of international financial integration today is less than is commonly assumed, and certainly much less than domestic financial market integration. As a result, there still remains a significant risk that US current account adjustment could prove to be less smooth than the optimists would hope.<sup>12</sup>

**Distributing the burden of global exchange rate adjustment**

Regardless of whether US current account adjustment continues to be gradual, or turns into something much more dramatic, the greenback is likely to play an important role. Indeed, for much of the past year, there has been a fairly heated debate about how the burden of exchange rate adjustment should be distributed across the rest of the world economy. To date, the bulk of bilateral currency moves have come in the form of substantial appreciations for the floating exchange rates of the advanced economies, including the euro, the A\$, the NZ\$, the Canadian dollar and sterling. In contrast, the big exporting economies of East Asia have proved reluctant to countenance exchange rate appreciation for fear of the adverse effect on their

<sup>10</sup> Freund (2000)

<sup>11</sup> Greenspan (2003b)

<sup>12</sup> Obstfeld and Rogoff (2000)

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international competitiveness. This has helped limit the degree of US dollar depreciation measured on a trade-weighted basis.

Country weights in the US broad exchange rate index	
	% of total
NAFTA (Canada & Mexico)	27.5
Euro-area	18.5
Other advanced economies	10.1
East Asia	37.8
o/w Japan	11.1
China	9.8
Other East Asia	16.9
Other emerging markets	6.0

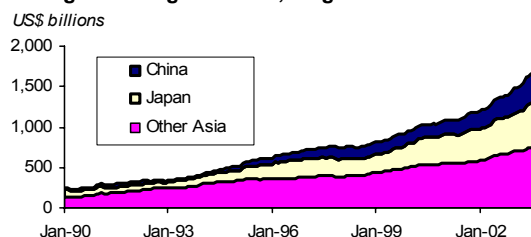
Source: US Federal Reserve

Japan, for example, spent a record 20,075b yen on currency intervention in 2003 (dwarfing the previous high of 7,641b yen spent by the finance ministry in 1999). This succeeded in capping the rise in the yen against the greenback to 10% last year.<sup>13</sup> Meanwhile the other great regional trading power - China - has resolutely maintained its policy of pegging the RMB to the US dollar, prompting accusations in some quarters that Beijing is in some way gaining an “unfair” advantage for its exporters. Not surprisingly, with the region’s two heavyweights fending off currency appreciation, most of the rest of East Asia has followed.

One result of this policy stance has been a sharp increase in Asian holdings of foreign exchange reserves (excluding gold). These had risen to US\$1,762b by October 2003, or about 70% of total reserves, with East Asia alone accounting for about two-thirds of world reserves. Thus the intervention by Asian policymakers to hold their currencies down

against the US dollar – and the subsequent purchase of US government securities – has been a major counterpart to the rise in US current account financing from central banks noted above.

**Foreign exchange reserves, ex gold**



Source: IFS

Frustration with East Asia’s reluctance to allow currency appreciation has been expressed both in the EU and – more forcefully – in Washington (in practice most of the ire has been focused on China, with Japan apparently granted a partial exemption from condemnation given a perceived need to shelter its weak economy). Last September the G7 issued a communiqué from Dubai calling for more currency flexibility, and the IMF made a similar suggestion in its World Economic Outlook publication, in which it called for a move to greater exchange rate flexibility by the Asian economies. The Fund remained vague on timing, however, noting only that China should recognise the “importance of moving gradually to greater exchange rate flexibility.”<sup>14</sup>

In a paper that was frequently cited towards the end of last year, three economists suggested that the predilection for East Asian economies to (formally or informally) peg their currencies to the US dollar had led to the emergence of what they described as a revived Bretton Woods system.<sup>15</sup> This system has a

<sup>13</sup> Jopson (2003)

<sup>14</sup> International Monetary Fund (2003)

<sup>15</sup> Dooley, Folkerts-Landau and Garber (2003)

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US economy at its centre that provides a ready market for a ‘periphery’ which relies on export-led growth boosted by undervalued exchange rates. They argue that this was precisely the development path that was followed by Western Europe and Japan under the original Bretton Woods system of fixed exchange rates introduced in the aftermath of the Second World War, and that the same path is now being taken by China and the rest of East Asia, with India set to follow. In this view of the world, the economies of East Asia will remain happy to fund the US current account by investing in US securities – and to accept a relatively low return while doing so – since they are in effect lending the US money that will then be spent on purchasing their exports.<sup>16</sup>

This model also provides an interesting framework within which to analyse the current argument over whether China should move to a more flexible exchange rate regime, and allow the RMB to rise against the greenback. Those arguing that China is right to maintain its currency peg to the US dollar can argue that China is still part of the periphery, an emerging market with a weak financial system that is not yet ready for a floating currency. Those on the other side of the debate can point to China’s growing share in world output and trade which make it look more like a global economic heavyweight – placing it in the same category as those advanced countries that are willing to allow their currencies to float. The conflicting opinions over which is the correct view of China – vulnerable emerging market or global economic power – are matched by differing views over the appropriateness of China’s exchange rate policy (a similar debate took place over the terms of China’s admission to

the WTO). The complication of course is that *both* descriptions have some merit.

Is US external adjustment possible without further adjustment in the greenback? As noted above, past experience suggests that current account adjustment typically requires real exchange rate depreciation, and in a world of less than perfect price flexibility, adjustment of the nominal exchange rate is likely to be the most efficient way to generate the needed decline in the real rate. The alternative – deflation – would be much more painful. However, to the extent that there is substantial excess capacity available in those economies running the current account surpluses that are the counterparts of the US deficit, the degree of required real depreciation, and hence of US dollar adjustment, would be reduced by faster growth in the rest of the world economy.

**Global re-orientation and Sino-US trade strains**

If the exchange rate adjustment channel were to be stymied, would the US look to trade policy solutions? In the same speech that argued that greater international economic integration made global adjustment to the US current account imbalance an easier task, Greenspan also noted one major caveat to his optimistic take on matters, warning that “clouds of emerging protectionism have become increasingly visible” and that this trend “could significantly erode the flexibility of the global economy”.<sup>17</sup>

One obvious area of emerging protectionist pressure in 2003 was in the context of Sino-US trade relations. While from an economic perspective the key US external imbalance is the overall current account position, for much of last year *political* attention focused on just one component of that

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<sup>16</sup> They also note that there is a third region under this system that allows its currencies to float against the US dollar. In their model this part of the world will face steadily appreciating exchange rates, and as a result a steady loss of market share to Asia.

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<sup>17</sup> Greenspan (2003b)

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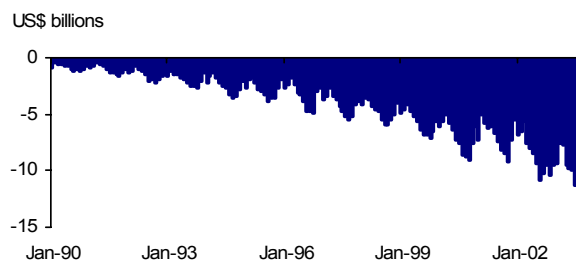
aggregate – the bilateral trade deficit with China.<sup>18</sup> According to US data, that deficit blew out to over US\$100b in 2002, and was headed for a US\$125-130b shortfall in 2003 after reaching US\$123b in the 12 months to October 2003.

Why the focus on the bilateral trade balance? The sheer size of the deficit and the pace of its increase is clearly part of the story. But so is the fact that the growing US trade deficit with China has occurred at a time when the latter is becoming an increasingly important player in the world economy. China's share of world trade has risen from less than 1% of the total in 1979 to 5½% in 2003 – a more than five-fold increase over a short time span.<sup>19</sup> This rapid pace of integration into the world economy has been powered by a wave of foreign direct investment that has allowed China to become internationally competitive across a wide range of goods, from light, low-end manufacturing products such as clothing and footwear through to more sophisticated items such as electronics. As a result, China is now a key part of the global supply chain.<sup>20</sup> The general adjustment strains associated with the consequent shift in global economic weight towards China are almost certainly another factor behind current Sino-US trade tensions.

The impact of this process of global re-orientation has been reinforced by the fact that it is taking place at a time when international trade in goods and services has reached an unprecedentedly high share of global output. The ever-deeper penetration of trade into national economies is creating increased economic uncertainty for workers and hence new constituencies for protectionism, even as it is also boosting productivity and providing consumers with

new and cheaper goods. As a result, trade is becoming a 'hot button' political issue, particularly with US presidential elections due this year, and with public debate again starting to link de-industrialisation to trade (by the end of 2003 US manufacturing employment had been falling for forty consecutive months with the loss of 2.8m jobs).<sup>21</sup> Already, most of the leading Democrat candidates campaigning for the presidency have claimed that the Bush administration's failure to deal with China has contributed to a loss of US manufacturing jobs.<sup>22</sup>

**US bilateral trade balance with China**



Source: US Census Bureau

Protectionist rhetoric is not an unexpected feature of presidential campaigns. But the rising political interest in this issue last year was also evident in the introduction of several bills into Congress and the Senate, including proposals to levy tariffs on Chinese imports in proportion to the purported degree of undervaluation of China's exchange rate against the greenback, and to withdraw China's Permanent Normal Trading Relations status. Moreover, there have already been concrete moves to tighten trade controls on China. On 18 November 2003 the US said it would limit imports of some Chinese textiles and apparel, and later the same month the Commerce Department issued a preliminary ruling

<sup>18</sup> This is discussed in an earlier *Issues Brief*. See Thirlwell (2003d)

<sup>19</sup> Prasad and Rumbaugh (2003)

<sup>20</sup> Hale and Hale (2003)

<sup>21</sup> Forney (2003)

<sup>22</sup> Alden (2003)



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claiming that Chinese TV manufactures were dumping their products in the US, and announcing the imposition of provisional anti-dumping duties.

While China-bashing may make sense in narrow political terms, however, the likelihood that levying trade restrictions on Beijing would dramatically improve the employment picture for manufacturing is remote. True, increased competition from China has undoubtedly had some impact on manufacturing sector employment. But it is only one of several factors at work, including strong productivity growth, and is almost certainly not the dominant explanation for a decades-long decline in manufacturing employment. It is notable for example that the five industries that have contributed the most to US manufacturing job losses over recent years are industries where imports from China are relatively small.<sup>23</sup> In fact the majority of Chinese imports probably compete with products from other developing countries, and not with US producers. So targeting China would likely only shift production to other overseas exporters.<sup>24</sup>

**The rise of India and the international outsourcing debate**

While China is currently the driving force of global re-orientation – and partly as a result has become the target of choice for many protectionists – the past year also saw a growing focus on the improving economic performance of India. Due in part to the positive effects of a good monsoon season on the economy's large agricultural sector, growth in the current fiscal year is expected to exceed 7%. Such an outcome would confirm India as the second-fastest growing (large) economy in the world and this prospect has generated much speculation as to

whether India will follow in China's footsteps and become another Asian economic giant.<sup>25</sup> While a large part of the current Indian growth story is cyclical, reflecting as it does the boost from improved weather conditions, there is also a case to be made that India is now reaping some long-term payoffs from the country's earlier structural reforms. Thus Goldman Sachs last year estimated that the Indian economy could be the third largest in the world (behind the US and China) in thirty years time.<sup>26</sup> Indeed, some commentators even speculated that despite a poor relative performance in historic terms, India's long-term economic prospects could turn out to be better than China's.<sup>27</sup>

At the same time, and in a close parallel to the way in which the rise of China has generated fears over greater competition in manufacturing, the pickup in Indian economic growth has been associated with a growing debate over the implications and magnitude of international outsourcing or off-shoring, including speculation that "India may do for services what China already does for manufacturing."<sup>28</sup> International outsourcing of low skill services jobs was already underway in the 1990s, but as "the migration of white-collar work has moved up the value chain from call centre operators and back-office clerks to occupations such as equity research, accounting, computer programming and chip design" it has achieved a sharply higher profile. For some commentators the trend "heralds a fundamental restructuring of rich-world economies, akin to the globalisation of manufacturing in the 1980s and the outsourcing of unskilled service jobs in the 1990s."<sup>29</sup> To date, the move by companies in advanced economies to outsource skilled service

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<sup>23</sup> Mankiw (2003)

<sup>24</sup> Greenspan (2003a)

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<sup>25</sup> Waldman (2003)

<sup>26</sup> Wilson and Purushothaman (2003)

<sup>27</sup> Huang and Khanna (2003)

<sup>28</sup> The Economist (2003a)

<sup>29</sup> Roberts and Luce (2003)



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sector jobs to offshore locations has affected only a relatively small number of jobs, although the numbers are growing.

One result is that outsourcing has now joined competition from China as a subject for political debate. Again, this has particularly been the case in the US, which by one estimate accounts for over 70% of all current off-shoring business.<sup>30</sup> In a much-quoted study, Gartner Associates has calculated that 1 in 10 US IT jobs will have moved to emerging markets by the end of this year, while Forrester Research estimates that over a 15 year period around 3.3m US white collar jobs will move offshore.<sup>31</sup> Goldman Sachs estimates that the majority of the 200,000 service jobs that have *already* been outsourced over past three years have gone to India. This has already triggered a hostile political response in several US states, with New Jersey last year proposing to introduce a bill that would prevent the use of foreign workers to meet state contracts, and at least eight other states are reported to be considering anti-outsourcing legislation. In response India has felt compelled to launch a lobbying campaign to improve the country's image in the US.<sup>32</sup>

Is the furore over outsourcing overdone? Morgan Stanley's chief economist Stephen Roach is one of those who take a pessimistic view of recent trends. He links outsourcing to the phenomenon of "jobless recoveries" in the advanced economies and worries that the "global labor arbitrage" associated with the rise of manufacturing platforms in China and service sector outsourcing to India is creating a "fundamental breakdown in the relationship between aggregate demand and employment in the

United States."<sup>33</sup> But this is probably being too gloomy. Like international trade in general, outsourcing has the potential to create significant economy-wide benefits, even as it disadvantages certain sections of the population. For example, Catherine Mann at the Institute for International Economics reckons that – just as the globalised production of IT hardware led to lower prices in the 1990s that were followed by a wave of innovation and investment – the globalisation of IT services and white collar jobs will generate a second wave of innovation and productivity growth.<sup>34</sup> She argues that while this will raise "the specter of losing 'white collar' IT jobs abroad" such projections neglect the fact that the process "will yield even stronger job demand in the US for workers with IT proficiency and skills."

**The multilateral trading system under pressure**

Still, even if Roach's pessimism proves to be unfounded, the adjustment strains generated by the economic rise of China and India and by the way in which the world economy adjusts to a US current account correction will need to be carefully managed over coming years. The good news here is that the global economy already has an organisation – the WTO – and a policy framework – the multilateral trading system – within which to manage such strains. The bad news is that both the WTO and the trading regime it supports are in some trouble.<sup>35</sup>

The last successful multilateral trading round – the Uruguay Round – was concluded almost a decade ago, and initial efforts to generate a new round ended in debacle at Seattle in 1999. The Doha

<sup>30</sup> The Economist (2003a)

<sup>31</sup> Morrison (2003)

<sup>32</sup> Schroeder (2003)

<sup>33</sup> Roach (2003)

<sup>34</sup> Mann (2003)

<sup>35</sup> A recent Lowy Institute working paper provides a detailed review of some of the challenges facing the international trading system Thirlwell (2003b)

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Round was finally launched in November 2001, but the collapse of the WTO ministerial meeting in Cancún in September last year represented a severe blow to the process, with the Doha trade round left, if not quite dead, then “in need of intensive care” according to EU trade commissioner Pascal Lamy.<sup>36</sup>

One notable feature of last year’s events in Mexico was the role played by the G22 group of developing countries, led by China, India, Brazil and South Africa and representing half of the world’s population and two-thirds of its farmers.<sup>37</sup> The emergence of the G22 as a negotiating force in international trade in 2003 is another reminder of the gradually shifting balance of economic weight in the international economy.

Following the failure at Cancún, the WTO set 15 December 2003 as a new deadline to restart talks at a meeting of General Council in Geneva. But that deadline also passed with no success, and the Doha Round now looks extremely unlikely to be completed by its scheduled date of January 2005. Delays and missed deadlines are par for the course in international trade negotiations, and observers such as eminent trade economist Jagdish Bhagwati have argued that ultimately self-interest should help get multilateral trade negotiations back on track.<sup>38</sup> This may yet prove to be the case. But it also seems clear that there is now a growing risk that the current trade round may struggle to deliver.

If the Doha Round does disappoint, then the growing tendency for countries to look outside the multilateral system to preferential trade agreements – through initiatives such as regional and bilateral trade deals – will be given a further push: the heads

of the World Bank and the IMF have both warned that further delays to the negotiations would accelerate the trend towards preferential trade agreements.<sup>39</sup> US trade representative Robert Zoellick responded to Cancún by saying that the US would now seek to “move towards free trade with can-do countries”, in effect by negotiating preferential trade agreements.<sup>40</sup> The US has already signed agreements with Jordan, Singapore and Chile, and the first of these deals to be negotiated entirely on the Bush administration’s watch was concluded on 17 December 2003, with four Central American economies (El Salvador, Honduras, Nicaragua and Guatemala) signing up. Several other countries, including of course Australia, are also in the process of either discussing or negotiating future free trade agreements with Washington.

**Implications for the international economy in 2004**

The trends that helped shape the international economy in 2003 are likely to be important again this year.

With the US current account deficit on track to reach new highs in 2004, the pressures for external adjustment – including additional exchange rate adjustment – also look set to continue. This means that arguments over how best to manage that process will again be a feature of the international policy debate this year, and the future of China’s exchange rate policy will continue to be the subject of speculation.

While the impact of last year’s G7 Dubai communiqué proved to be relatively short-lived, some economists have called for a return to

<sup>36</sup> Jonquieres (2003)

<sup>37</sup> The Economist (2003b)

<sup>38</sup> Bhagwati (2004)

<sup>39</sup> Kohler and Wolfensohn (2003)

<sup>40</sup> Zoellick (2003)

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international policy co-ordination of the kind that allowed currency adjustment between the Plaza Accord of September 1985 and the Louvre Accord of February 1987.<sup>41</sup> But the G7, with the exception of Japan, has become reluctant to engage in large-scale currency intervention. Instead, policy co-ordination in recent years has tended to focus on information exchange, reducing the focus on specific policy agreements in favour of looking at the general direction of policy.<sup>42</sup> In addition, the ability of the G7 to influence markets is likely to have declined relative to the 1980s, given the growing scale of the foreign exchange market and the gradual decline of G7 members' global economic weight.

Since external adjustment pressures are set to continue, trade policy tensions will also remain a feature of the international economic environment. In particular, with US presidential elections due this year, the political importance of trade policy is unlikely to subside any time soon. For example, Democrat candidates are due to take part in the South Carolina primary on 3 February 2004 in a state which has lost nearly 65,000 textile and apparel jobs over the past decade, and where around sixty textile plants have closed since 1999.<sup>43</sup> International trade looks like an obvious scapegoat, and the realities of an election year could complicate attempts to re-invigorate the Doha Round.

The prospect of more international trade frictions this year could also be given a boost by the expiry in December 2003 of the WTO's so-called "peace clause", a nine-year old agreement that granted agricultural export subsidies temporary immunity from WTO-mandated retaliation. One concern is that with the expiration of this agreement the big

trading powers – who also happen to be among the biggest users of agricultural subsidies – may find their enthusiasm for the WTO under even more strain.<sup>44</sup> Still, these pressures could be offset somewhat by the prospect of stronger growth for the world economy – and hence for international trade – thanks to the current cyclical upturn.<sup>45</sup> All else being equal, protectionist demands tend to be less strident when trade growth accelerates.

**Implications for Australia**

What will this international environment mean for Australia? Growth in 2004 will reflect the way in which the tailwinds provided by a stronger global growth outlook are (partially) offset by the headwinds created by a stronger A\$. A key factor to watch however will be how the A\$ responds to the continuing process of global exchange rate adjustment. Australian policymakers need to be aware of the possibility of a significant overshoot of the A\$ and of the potential dangers involved if US current account adjustment proves to be much less smooth than current forecasts anticipate.

The international economy is also likely to raise some longer-term strategic issues for Australian policymakers. These include the need to adapt to the rebalancing of global economic weight towards Asia. The trend of global re-orientation should provide Australia with important long-term economic benefits, but the transition process will also probably create some economic management challenges. Similarly, policymakers will have to balance the time and effort needed to resuscitate the multilateral trade round with the requirements involved in existing free trade negotiations with the

<sup>41</sup> Bergsten (2003)

<sup>42</sup> Meyer, Doyle and Gagnon (2002)

<sup>43</sup> Espo (2003)

<sup>44</sup> The Economist (2004)

<sup>45</sup> For a take on the prospects for stronger global growth this year see Thirlwell (2003c)

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US and the possibility of future negotiations with China. In the case of the former, the rise of the G22 as a negotiating force may prove to have implications for the role of the Cairns group in WTO negotiations, and hence for Australia's multilateral trade policy strategy. In the case of the latter, policymakers will have to weigh the defensive benefits of securing deals with key trading partners in the current uncertain trading environment against possible collateral damage to an already fragile multilateral trading system. They will also have to take into account the far-reaching economic, political and strategic implications that any comprehensive trade agreement with Beijing would entail.

**What might change the outlook?**

While the most likely outlook for the international economy over the next year or so is one in which a cyclical upturn plays out against the backdrop of the external adjustment processes described above, several risks are worth noting.

On the downside, this Issues Brief has already flagged the possibility of a sharper-than-expected US current account adjustment. In addition, two hard-to-quantify risks are the danger of another terrorist spectacular and the possibility of a second major SARs outbreak or a similar global health scare. Either event could undermine global confidence and threaten to upset the current consensus forecast of stronger growth for 2004 and 2005.

Another risk is that the large degree of monetary and fiscal pump priming that has taken place in recent years, particularly in the US, will produce inflationary pressures more quickly than either financial markets or central banks now expect. A surprise surge in inflation would place policymakers under pressure to hike interest rates sooner and more

sharply than the consensus currently assumes. This in turn would place highly-leveraged household balance sheets under significant strain.

On the upside, US economic prospects could be given a big lift from faster productivity growth. Since the end of the Second World War, US productivity has grown at an average annual rate of a little over 2%. But while productivity growth between 1973 and 1995 averaged only 1-1½%pa, since 1995 productivity has risen at an annual rate of about 3%. And in the past two years, labour productivity has surged by more than 5%pa.<sup>46</sup> It is possible that these latest productivity numbers could signal a further acceleration in productivity. A sustained increase in trend productivity growth would make a substantial contribution to resolving the economic imbalances in the US economy: the resultant increase in the tax base would imply a significant fall in projected budget deficits, for example, and hence reduce some of the concerns relating to medium-term fiscal sustainability.<sup>47</sup>

Finally, it is also possible that the productivity gains enjoyed by the US (and Australia) during the 1990s could spread to other advanced economies, leading for example to a marked improvement in the Euro area's hitherto lacklustre growth performance. As noted above, such a result would ease the US current account adjustment process, which would also take some of the sting out of the debate over the global distribution of trade and currency adjustments.

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<sup>46</sup> Ferguson (2003)

<sup>47</sup> Office of Management and Budget (2003)

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