

## The world economy

### Running out of puff?

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#### The global economy may not be as strong as it looks

SPRING in Washington means the arrival of cherry blossom and, less colourfully, the world's central bankers and finance ministers, for meetings of the World Bank and the International Monetary Fund. As the officials gather this weekend, their mood might not match the season. Top of their list of worries is the thought that high oil prices might be pushing the world economy into trouble.

Although oil prices took a tumble this week (see [article](#)), the policymakers' concern is understandable. Oil prices are still 70% higher in real terms than they were two years ago. Granted, that pales against the great leaps of 1974, when prices jumped by 185% in real terms, and 1978-79, when they rose by 158%; but it is quite some climb nonetheless.

Lately, official worries have been publicly vented. On April 7th economists at the IMF caused a stir when they suggested the world needed to get used to a "permanent oil shock". Thanks to strong demand and tight supply, they argued, oil prices would be substantially higher in future than they had been in the 1990s. Jean-Claude Trichet, president of the European Central Bank, recently pointed to the rise in oil prices as an "unwelcome" risk to global economic growth. In a comment reminiscent of the 1970s, he urged consumers to become "good energy savers".

His remark is not surprising, given that the economies in Europe are stumbling. Unemployment in the euro area is 8.9%; in Germany, France and Spain it is in double digits. Manufacturing in the

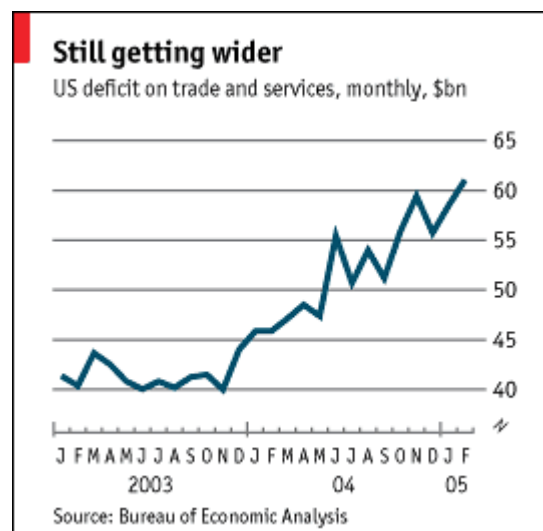
single-currency zone has stalled. In its latest World Economic Outlook, published this week, the IMF, like other forecasters before it, slashed its forecast for euro-area GDP growth this year, to 1.6%. The world economy's other weak link, Japan, faltered half-way through 2004 and despite the odd spark has not yet sputtered into life again. Rising oil prices have helped neither of these giant weaklings.

Even in America, where the strength of the expansion has consistently surprised economists, there are nascent signs of slowdown and worries about oil. With job growth scarcely topping 100,000, the March employment report was much weaker than expected. Retail sales grew by only 0.3% (month-on-month) in March, less than half of what analysts had expected, suggesting that record petrol prices were wearing holes in consumers' pockets.

No wonder that oil will be high on the agenda in Washington this weekend. In the World Economic Outlook, the IMF reckons that global growth in 2005 will be 0.8 percentage points lower than last year. It ascribes around a third of the reduction to higher oil prices. Even that forecast was based on prices slightly lower than they are now. More worrying, economists think that oil prices do not have a linear impact on output. Beyond some point (trouble is, no one knows what) they begin to hit harder.

So far, however, it is perhaps remarkable how little impact rising oil prices have had. Last year, after all, global GDP grew by 5.1%, the fastest rate in a generation. There are several reasons for this. The world economy is much less oil-intensive than it used to be. In contrast to the supply shocks of the 1970s, much of the recent run-up in prices has been caused by rapidly rising demand: oil is dear in part because some economies, especially America's and China's, have been growing vigorously. Central banks' strong reputations for fighting inflation have stopped the translation of higher oil prices into wage-price spirals. These fortuitous conditions may not last, but for now they are good reasons not to be too pessimistic.

High oil prices do, however, exacerbate the real weakness in the world economy: the imbalanced nature of global growth. Behind the robust overall performance lies a stark dichotomy between the robust (America and China, in particular) and the wheezing (Japan and continental Europe). Even though all these countries are oil importers, they have reacted very differently to higher prices. America and China have, so far, shrugged them off, while weaker economies have seen domestic demand shrivel further. This has exaggerated already gaping external imbalances, particularly America's soaring trade and current-account deficits.



According to statistics released on April 12th, America's monthly trade deficit reached a record \$61 billion in February (see chart). The climb in oil prices may mean another record in March—although much of February's increase reflected sharp growth in non-oil imports, which were 16% higher than in February 2004.

Brad Setser, a former Treasury official who is now at Roubini Global Economics, an economic-analysis firm, reckons that if non-oil import growth continues at its recent pace and the oil price stays over \$50 a barrel, America's annual trade deficit would reach nearly \$800 billion by the end of the year. That said, the figure may not get that high, because \$50 oil ought to dampen American consumer demand and hence import growth.

## **Be happy, it's spring**

It is possible to be sanguine about America's ever more colossal deficits, just as it is about oil. Certainly, the doomsday scenarios of a dollar crash or a hard landing for the American economy are not in sight. America has had little trouble attracting the necessary capital to fund its soaring deficits. Though Asia's central banks are still big purchasers, they are not the only ones. Thanks to soaring prices, oil exporters have been building up their surpluses. Russia's foreign-exchange reserves, for instance, are now over \$130 billion. Many of these oil exporters are choosing dollar assets. The dollar has strengthened since the beginning of 2005 and long-term interest rates remain remarkably low.

This calm may explain why the world's finance ministers have done so little to wean themselves off their addiction to American-led growth and why they will spend most of their time in Washington fretting about oil. That is a pity, for while the oil price seems to be the most imminent risk, the size and rate of growth of the global imbalances are the real reason to worry. If the world economy continues on autopilot, those imbalances are set to increase. And you do not need to be a Cassandra to predict that, eventually, they will create a nasty problem.

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