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The World Economy: A Washington Perspective

It is a pleasure for me to be here with you today and I look forward to our discussions very much. The world economic outlook has long been a topic of interest to me. Focusing on the interactions of the various major players in the global economy helps to set the parameters for policy makers. Not that they always pay attention!

When I was a young economist at the U.S. Treasury Department in the early 1970's I initiated a project to forecast short-term developments in the world economy. At that time, the IMF had not yet started its annual global forecasts. The project focused on macroeconomic developments – real growth, inflation, unemployment, and balance of payments. The global outlook discussion was broken down into individual Industrial Economies (essentially the OECD); major individual and some regional groupings of the LDCs as we called them then; and the rest of the world (the planned economies of the Soviet Union and China). Group averages were calculated with a focus on the relative performance of the different groups. By studying the individual forecasts and group outlooks it became possible to judge the consistency of the individual projections. For example, if all individual projections suggested current account surpluses, it became obvious that there were inconsistency problems in the global outlook.

After considerable effort I proudly circulated the first edition of Treasury's World Economic Outlook in the late summer of 1973. It was just in time for preparations for the fall International Monetary Fund annual meetings.

Then in October of 1973 the first oil crisis began with the embargo of the US and the original quadrupling of oil prices by OPEC. So much for my first forecasts! I learned a wonderful lesson early in my career. Don't put too much faith on forecasts! And when reviewing forecasts look carefully at the underlying assumptions! Most forecasters can 'assume' the results they expect by choosing the starting assumptions carefully!

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Today I would like to discuss three basic views of the world economy: The short term outlook for the rest of this year and early 2007; the medium term outlook for the next one to four years; and the long term outlook for the next 10 years or so. Each of these time frames bring different issues to the forefront and will pose different problems for policy makers around the globe. The policy choices made today will affect importantly the medium and longer term outlooks. Unfortunately I believe that too many of our policymakers focus on the next election and not on the medium or long term problems for our economies.

Short-term outlook.

Virtually all economic forecasters expect a continued strong performance for the world economy in 2006 and into 2007. Real GNP in the industrial countries will continue to record solid (though not historically strong) growth this year and next. Most forecasts are suggesting that world real GNP will grow on the order of 5% in both 2006 and 2007, with a very modest slowing during 2007. Industrial countries are likely to grow in the 2 ½ to 3% range while emerging markets are expected to growth on the order of 6 ½ to 7%.

Most likely the US will continue to lead the performance of the industrial countries as it has for the past decade or so. US real growth will likely be on the order of 3 – 3 ½ percent. Japan will likely exceed the 2% range – a welcomed change from the past decades' lack luster performance. Europe continues to under perform both its own historic averages and that of its industrial country partners. Analysts expect something around 1% for 2006 and 2007 in the European area. And most of that growth comes from the external sector.

Inflation concerns are higher today than they were a year ago. The very large rise in oil prices are now working through domestic economies and core inflation rates have begun to rise. Analysts now see 2-3 percent inflation rates in the industrial world for the next year or so. Emerging countries are more likely to see inflation rates in excess of 5 percent. The energy sector does not appear to be significantly out of balance, but there is clearly a significant speculative bubble in short term prices. And most analysts did not anticipate the rapid shift in China's global demand for oil and gas imports. In a very short time, China has become the world's second largest importer of oil.

If growth and inflation seem to be under control, what are the worries in the short-term outlook? Clearly the most significant concern centers on the very large and historically unsustainable external imbalances being amassed by the United States.

The US current account deficit is now expected to exceed 7 percent of GNP this year and next. Historically when the deficit has surpassed 4 percent, global financial markets have reacted negatively. Foreign exchange markets have experienced turmoil and the dollar has come under significant pressure to depreciate.

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For the past several years now, the US current account deficit has grown well beyond the historically unsustainable levels. At some point in the near future, we should expect that foreign purchasers of dollar assets will feel that there is a risk associated with dollar assets and will demand either a significantly higher rate of return on those assets, or will start moving into other currency denominated assets. In either event, the dollar will start to adjust in value terms.

Of course predicting the timing of an exchange rate adjustment is impossible. What we can foresee however, is the need for an adjustment of significant size. Whether the adjustment will occur smoothly and slowly or abruptly will determine the health of the world economy. We should expect an adjustment of 20-30 percent in the dollar exchange rate vis a vis other major currencies. An adjustment of this magnitude will of course affect the domestic economic outlook for the European and Japanese economies.

And the currencies of major emerging markets such as China will need to adjust as well. Those currencies tied directly or indirectly to the dollar also need to re adjust their values in order to facilitate the global adjustment process.

Another short term issues revolves around the future of the global trading system. The Doha Round is not likely to be completed in its present form and scope. If there is further progress in the negotiations it will most likely be on the basis of a significantly reduced agenda. It is clear that the WTO members on a whole do not want to face the difficult choices involved in the current agenda.

In the meantime, a significant number of new bilateral trading arrangements are being negotiated throughout the global economy. Particularly noteworthy has been the fundamental change in Japanese trade policies. After decades of resisting bilateral trade deals, the Japanese government has completed a number of economic partnership arrangements and has others under negotiation. I would argue that these arrangements are more on the order of preferential trading arrangements than FTAs. They probably would not pass an old fashioned GATT test of covering significantly all trade. But they do represent a change in the global trade regime.

The US continues to negotiate bilateral FTAs along the lines of NAFTA. These deals appear to be consistent with the framework of global trading system, but they do distract from the Doha Round efforts and focus I believe.

The final worry about the short-term outlook is the energy market. Speculative forces have added roughly \$10-15 a barrel to the spot price of crude oil. Instead of the \$70 plus range per barrel we should see something on the order of \$55-60 if supply/demand forces cleared the market. But worry about the middle east, Iraq, and the situation in Venezuela have added speculative pressures to the market. Additionally we saw that with the

historically destructive effects of hurricane Katrina in the US that refining capacity is very tight in the US and other major markets. Any short term disruption to oil markets will be quickly and significantly reflected in spot prices.

Medium Term outlook.

In the 2008-2010 period, energy markets will likely dominate the global situation. In addition, the anticipated cyclical slowing in the United States will weaken industrial country growth performance unless Europe is able to solve its domestic growth problems.

In Asia, there will be questions about the sustainability of China's strong growth. Infrastructure problems are beginning to be seen inside China and they will worsen over the medium term. Electricity production will require considerable capacity expansion in order to meet rising demand. This will necessitate a larger inflow of foreign capital and perhaps privatization of the electricity sector.

In addition, the highway system, railroad system, and port and airport facilities will need expansion. In sum, considerable investment in infrastructure is required. Whether China will be able to finance this purely with domestically generated funds, or will need to open its markets to foreign investment flows will be interesting to watch.

In a similar vein, India faces the same infrastructure problems as does China. Power generating capacity, roads, railroads, port and airport facilities. And both countries will face the need for significant liberalization of their financial sectors partly in reflection of the infrastructure investment requirements.

Here in Russia, there will be questions to face about the 'rule of law' issues in the domestic economy. What will the regulatory regime look like for corporations? What will the judicial system look like for lawsuits and ownership issues? How will contract law develop?

In Japan -- and to a lesser extent in the United States and Europe -- the problems of an aging society will start to be felt over the medium term. A declining work force size and increased spending out of prior savings will change the face of the Japanese economy. Authorities need to address the problem of the choices involved in attracting new workers to the domestic economy both from inside Japan (basically allowing women to hold senior positions) and from outside (a need to change their immigration policies). The aging society will result in demands on health care and housing which will be very different from the last 50 years of the post war recovery and expansion.

In Europe we witnessed the social reaction to one of the major structural problems in France last winter. The violent strikes over what outsiders would consider to be relatively modest changes in labor laws provides insight into the problems of creating

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labor market flexibility in France. These problems are probably mirrored in other European countries as well I suspect. With unemployment stuck in the double digit range for more than 20 years, the social effects of long term unemployment are significant and not well understood.

More generally, European labor and product market inflexibilities result in the underperformance of economies. Growth continues to be significantly lower than in the economies of Europe's major trading partners. Unemployment rates are considerably higher than in other parts of the world. It would appear that European preferred social policies are hindering the competitiveness of Europe in the global market place. But so long as voters continue to support these policies there is little pressure for change.

Longer-term Issues.

A significant number of issues will need to be addressed by policymakers over the longer-term.

Energy market development in the rapidly emerging economies of China and India needs immediate attention. Both countries subsidize electricity rates and both over consume as a result. They are both in serious need of energy efficiency approaches to growth and need environmental reforms throughout their economic structures. The rest of the world will suffer energy shortages if these two don't make changes.

Alternative energy supplies need to be developed. Oil resources will move into tighter supply situations over the longer term on the basis of today's estimated reserves.

Aging populations in Europe and Japan will alter the underlying demand for services. In the US the aging native population is currently projected to be supported by immigrations. If US immigration policy is fundamentally altered there will be growth problems. In any event, there will be a significant change in the demand for housing and services, particularly health care services.

Global trade integration will be interesting to watch. Will the failure of Doha result in more bilateralism, the creation of trade blocs, or a renewed push for global liberalization. I suspect it will be blocs.

Thank you.