THE WORLD ECONOMY

AND THE

OUTLOOK FOR THE UNITED STATES

Hearings Before the
Budget Committee of the
House of Representatives

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The US economy faces significant risks over the coming period. Developments in the financial and housing markets raise the specter of a sharp turndown or even a recession. High energy prices and the falling dollar, in the context of nearly full employment, trigger concerns about inflation as well. The current course for US policy, including fiscal policy per the mandate of this Committee, is thus much more complicated than usual.

My focus today will be on several aspects of the world economy, and the international economic position of the United States, that have an important bearing on these considerations. There is both good news and bad news on that front.

Global Economic Growth

The good news is that the world economy continues to expand robustly and thus provides an important buffer against significant cutbacks in US growth. Global expansion is running at about 5 per cent for the fourth consecutive year in 2007. Despite all the risks and uncertainties, and even if the US slows sharply, world growth is likely to approximate at least 4 per cent in 2008 for the sixth consecutive year.

The global economy has now in essence decoupled from the United States. As late as the 1990s, it could be argued that the world depended on the United States – that "the world caught pneumonia when the United States caught a cold." That is no longer true, however, as revealed by continued buoyant global expansion in 2006 despite the beginning of the US slowdown. In fact, my colleague Michael Mussa has correctly suggested that we are now witnessing "reverse coupling" in which the United States has become heavily dependant on developments in the rest of the world.

A major reason for this phenomenon is the dramatic increase in the global economic role of emerging market nations, especially China and India but many others as well. With exchange rates calculated at purchasing power parity, which is appropriate for these purposes, <u>the emerging markets now account for fully one half of the world economy</u>. They are expanding at 6-7 per cent annually and will thus sustain worldwide activity at a brisk pace even if the United States and the other industrial countries fall to 2 per cent or less.

This <u>robust global growth boosts the US economy directly by expanding demand for our exports</u>. <u>Exports in real (volume) terms have in fact been growing at more than 8 per cent for the past four years and at annual rates of 10-20 per cent for the past year, more</u>

than five times the pace of import increases. Hence our trade deficit, in real terms, has fallen substantially and added more than 1¼ percentage points to overall economic growth during three of the last four quarters. (In value terms, the external deficit has fallen by less because of the sharp rise in oil prices and in some other import prices due to the decline in the dollar.)

This compares with the subtraction of 0.5 per cent annually from US growth over the past decade due to the steady climb in the trade imbalance. This swing, of 1-2 percentage points annually, is a major positive component of the US growth picture that is likely to prevail for some time.

The US export boom is also being fueled by the sharp rise in US competitiveness stemming from the fall in the exchange rate of the dollar. The dollar has now declined by a trade-weighted average of 20-25 per cent since its peak in early 2002, correcting an important part (thought not yet all) of the overvaluation generated by its rise of about 40 per cent from 1995 until that time. Currency changes translate into recorded trade flows with a lag of two to three years and, in textbook fashion, the real trade deficit peaked in 2004 and has been coming down since.

I have testified to this Committee many times over the years that the large US external imbalances of recent years, and the overvalued dollar that helped produce them, were unsustainable and would have to come down. They would do so through a combination of a lower exchange rate and a slowdown in the growth of domestic demand (e.g., consumption and housing investment) coupled with improvement in our trade position. That is precisely the change in the composition of US growth that we are now experiencing and can expect to continue for at least a couple of years.

The good news from all this for the short run is that the strength of the world economy is likely to cushion the intensity of the coming downturn here at home. A world recession is inconceivable given the sharp momentum of the past five years and the robust outlook in most of the emerging markets. A US recession is not impossible but would probably be quite shallow, as in 2001, rather than sharp and steep as in the more typical past US experience. Trade improvement is in fact the strongest likely counterweight to the slowdown in domestic economic activity that is looming over the coming quarters.

The External Risks

The bad news, however, is that the continuing decline of the dollar could accelerate and add significant complications to our economic prospects and proper policy responses to them. There are at least four reasons to expect the dollar to keep falling, perhaps by another 10-20 per cent on a trade-weighted average, even without taking account of any broad collapse of market confidence in the US economy due to the subprime crisis and related developments:

- the current account deficit, though reduced, is still unsustainably high at more than 5 per cent of GDP;

- the US growth slowdown, relative to the rest of the world, reduces the appeal of investment in the United States;
- the associated reductions in short-term US interest rates also reduces the incentives for capital to move into dollar assets; and
- the creation and maturation of the euro provides, for the first time in almost a century, a real competitor to the dollar that is already triggering a structural portfolio adjustment into the world's second key currency.

A further decline of the dollar, if gradual and orderly as has been the case since 2002, is a desirable and indeed necessary component of completing the adjustment of the unsustainable US and international imbalances. However, markets frequently overreact and a free fall of the dollar could trigger sharp and sudden increases in US inflation and thus interest rates (especially if energy prices were to rise further at the same time). <u>This would push the economy in the direction of the stagflation of the 1970s</u> (albeit presumably with less intensity on either the "stag" or "flation" sides of the equation that occurred at that time).

Such a scenario could, at a minimum, limit the ability of the Federal Reserve to reduce interest rates to counter the economic slowdown (and provide additional liquidity to the financial markets). It might even force the Fed to raise rates to halt the currency depreciation. I believe <u>this is in fact the greatest risk to the "modest slowdown" prospect posited above as the most likely course for the US economy over the next year or so</u>.

Hence the United States might have to pay dearly now, in the teeth of a financial crisis and possible recession (in an election year), for living so far beyond its means for so long and thus becoming dependent on large continuing inflows of capital from the rest of the world. There are of course steps that the United States can take to minimize these risks. For this Committee and the Congress as a whole, the most important is by assuring continued reductions in the structural budget deficit with the goal of restoring the modest surpluses of 1998-2001 when economic growth returns to trend levels of 2½-3 per cent. This is the only way to assure that the United States will continue to benefit from global economic developments as it seeks to cope with the domestic difficulties that loom so importantly now and will inevitably arise from time to time in the future as well.