

Global Economic Prospects 2008/2009: Hoping for a Global Slowdown and a US Recession

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After four years of annual real GDP global growth averaging better than 4 1/2 percent, recent data indicate that the pace of advance is slowing in the industrial countries with the US economy on the verge of, and probably already in, outright recession. So far, most emerging market economies appear likely to maintain quite strong, albeit somewhat slower growth, than in recent years. Meanwhile, world consumer price inflation is up from barely 2 percent seven years ago to nearly 5 percent as of February. Among both industrial countries, except Japan and major emerging market countries, inflation is now running at, or in most cases somewhat above, rates consistent with policy objectives. Driven by persistently rising global demand, commodity prices continue to surge across the board, especially measured in US dollars, but also measured in terms of the rapidly appreciating euro.

In this situation, the world economy really needs what is now forecast: a significant slowing of economic growth, down to about 3 and 3 3/4 percent year-over-year this year, and 4 percent in 2009 from 4 3/4 in 2007. This slowdown will be led by a decline of demand growth in the US economy that is both pronounced and extends over a considerable period. Indeed, in view of the exceptionally aggressive easing of macroeconomic policies already in place in the United States, and the likelihood that monetary policy will remain highly accommodative so long as US financial markets remain under stress, it is now desirable that real GDP growth for 2008 fall to a forecasted rate of barely more than 1 percent year-over-year, an outcome consistent with a very mild and brief recession. Reflecting some risk of a deeper and more prolonged recession in the United States, the growth forecast for 2009 year-over-year is set at 2 percent.

For the rest of the world, a mild US recession this year will have modest negative impact on real GDP growth with more significant effects in Mexico and Canada. In some countries, where the slowdown threatens to become excessive and inflation is under control, some easing of monetary, and perhaps fiscal policies, is both likely and appropriate. More generally, however, it is too soon to call for a general and significant easing of macroeconomic policies. A slowdown in global growth is needed to cool the clearly apparent upsurge in worldwide inflation. Some countries, including Australia, China, and Sweden, have recently tightened monetary policies in efforts to forestall inflation. Other countries, including Canada and the United Kingdom, have eased monetary policies modestly in response to weakening economic growth. Quite appropriately, however, no country has so far followed the lead of the Federal Reserve in aggressive monetary easing.

As custodian of the world's second most important currency, the policy of the European Central Bank (ECB) is particularly noteworthy. Inflation in the euro area is running more than a percentage point above the ECB's announced objective. The euro area economy has been growing significantly more rapidly than its potential growth rate of about 1 1/2 percent. The unemployment rate has now fallen half a percentage point below the minimum reached during the last expansion. Key monetary aggregates are surging at rates well above their desired target ranges. In this situation, one would normally have expected the ECB to have raised its key policy interest rate a further 100 basis points since last summer. Instead, with the financial turbulence spreading, to some extent, from the United States to affect euro area financial markets and institutions with some evidence that the euro area economies are beginning to slow, and with sharp appreciation of the euro against the dollar likely to slow growth and impede inflation, the ECB has wisely held back from further interest rate increases. With the euro area economy now expected to expand at about a 1 1/2 percent rate this year in line with potential, the timing and direction of future adjustments in ECB interest rates appropriately will remain dependent upon the evolving balance of risk for inflation and economic growth. For Japan, the strengthening of the yen against the dollar in recent months and the weakening of exports to the United States, together with likely weakness in domestic demand growth, suggest the further write down of the forecast for 2008 to 1.2 percent, and I note that Japan along with Italy are countries where there is some risk of recession starting this year. For the industrial countries as a group, real GDP growth this year is now forecast to be just below 1 1/2 percent, and growth for 2009 is projected to be just below 2 percent.

In emerging market economies, circumstances vary and so do appropriate policies, but the general prospect is for continued quite strong economic growth despite the slowdown in industrial countries. Is this decoupling? Not really. Mexico, the Caribbean and Central American countries, and Asian economies that are particularly dependent on exports to the United States are already, and will continue to feel, the effects of the US economic slowdown. More broadly, however, strong growth of domestic demand in many emerging market economies will sustain reasonably strong GDP growth, and rising demand for raw materials by key emerging market countries, especially China, will help to keep commodity prices strong and aid growth in other emerging market economies. Overall, my forecast with developing emerging market economies as a group, growth this year and next will be about 6 1/2 percent, down from almost 8 percent in 2007. However, if the growth of the industrial countries, especially the United States, turns out to be significantly below the present forecast, then exports from emerging markets will be hit in volume terms, and prices of commodity exports could take a serious tumble. Some developing countries, especially among the primary exporters, could then face serious economic challenges and potential crises.

More specifically, China's economy continues to surge forward so much so that the authorities are tightening policies to cool down inflation. Growth will likely slow from about 11 1/2 percent last year to around 10 percent this year and next. On the policy front, the key action that should be taken, but that the Chinese authorities have so far refused to take, is a significant step appreciation of the renminbi against the dollar, in real effective terms, combined with policies to stimulate domestic demand. Arvind Subramanian will discuss the prospects for emerging Asia, especially India, in more detail in his remarks.

In Latin America, Mexico will suffer spillover effects from the slowing US economy, and growth this year will fall to about 2 1/2 percent before recovering modestly next year. In contrast, Brazil should be able to sustain growth of nearly 5 percent, despite the strong appreciation of the real against the dollar. Growth in Argentina and Venezuela is expected to slow from the high rates of

recent years, bringing down the growth rate for all of Latin America to about 4 1/2 percent this year, and slightly less for the next.

For Central and Eastern Europe, I expect the growth this year will run around 4 percent, reflecting the impact of slower economic growth in Western Europe, and I'm a little pessimistic about how Turkey will turn out in the current year. In the Commonwealth of Independent States, the dominant Russian economy should be able to sustain nearly 7 percent growth, and growth rates outside of Russia will be somewhat higher, as in recent years.

For the Middle East, high oil prices will help keep growth strong in the oil exporting countries. The larger and more diversified economies of Egypt and Israel should also maintain growth rates in the 5 percent range. High commodity prices will continue to benefit many African countries, and growth in this region appears likely to continue with at least a 5 percent rate.

Returning to the situation in the United States, recent economic data since late December suggested economic activity has been no better than flat since November and has probably been modestly declining early this year. The economic data do not indicate, however, that we are crashing into a steep recession. Annualized real GDP growth in the first quarter will likely be modestly negative, probably between minus one-half and minus one percent. The second quarter may see moderation in the pace of decline of residential investment, but the other elements of domestic demand are likely to remain quite weak. Another quarter of modestly negative real GDP growth now seems the most likely outcome. By June, the recently passed tax cuts will begin to bump up consumer spending, but I expected businesses will absorb some of this surge in consumption, particularly for durables into reductions in business inventories. On the other hand, business inventories have been kept quite lean for the past three years. This is a positive sign that the type of large inventory correction we have seen in past recessions is unlikely to occur on this occasion.

In sum, the prospect is that the US economy will bounce back to moderately positive growth this summer. By then, the massive contraction of residential investment that began two years ago should be complete. While consumer spending is likely to be weak after the effects of the stimulus are spent, inventory investment should bounce back and net export should continue to make positive contributions to GDP growth. With lagged effects of substantial monetary easing beginning to kick in late next year, it is reasonable to expect a rebound to moderate growth in the 2 to 3 percent range in the second half of the year. With real GDP falling modestly in the first half of the year and rebounding moderately in the second half, fourth-quarter-to-fourth-quarter growth should be about a meager one-half percent, and year-over-year growth is forecast to be barely more than 1 percent.

In comparison, in the 2001 recession, the mildest of the postwar era, fourth-quarter-to-fourth-quarter growth was 0.4 percent and year-over-year growth was 0.8 percent. The 2001 recession was followed by an initially weak recovery with the unemployment continuing to rise to a peak of 6.3 percent in May 2003. On this occasion, I also expected the economy will remain quite sluggish for five or six quarters after the middle of this year with a growth rate of only about 2 percent. Weak growth of consumer spending in the face of significant losses of household net worth associated with lower real home values will be a key reason for this sluggishness. Partly offsetting weak consumer spending growth will be continued improvements in US net exports, reflecting both slow import growth and continued rapid export growth. With the usual lag, the substantial

depreciation of the dollar over the past year will contribute to improvement in US net exports in 2009 and beyond.

The turmoil in global financial markets: A key feature and source of uncertainty in the present economic situation is the continuing turmoil in financial markets. This turmoil has been most severe in US financial markets and institutions, with problems in other countries mainly linked to their involvement with financial instruments originating in the United States. In the United States, the initial underlying difficulties arose from problems with subprime mortgages and the financial instruments involving such mortgages.

But the crisis is now much broader and deeper that can plausibly be explained by this underlying cause. The extent of this crisis in credit markets is even more remarkable in view of the exceedingly aggressive actions taken by the Federal Reserve and the important but less aggressive actions of other leading central banks. Contrary to the nonsense spoken by many financial market commentators, the Federal Reserve has not been behind the curve. The easing of US monetary policy in the present possible recession has far outstripped the pace of easing in past actual recessions. On top of this, the Fed has recently taken extraordinary actions to extend specific liquidity support to a wide range of US financial institutions. The official explanation for these extraordinary actions is not that they are motivated primarily by the desire to protect financial institutions from losses but rather to head off the risk of major damage to the general economy. So far, however, the general economy has not suffered substantial damage from the credit market turmoil beyond some deepening of the downturn in residential investment. The general slowdown that we are presently seeing in the United States and around the world is not much more than we would normally have expected in view of falling home values, higher food and energy prices, and other developments without the recent turmoil in credit markets.

Does this imply that the Federal Reserve, in its desire to protect the financial sector, has overreacted to credit market turmoil? Has it eased too aggressively, unduly raising the risk of inflation down the road? Has its rescue of the financial sector by massively cutting the cost of funds and providing specific liquidity support to individual institutions generated far too much moral hazard relative to the value of the protective effect of these actions against the real hazards faced by the general economy?

At this point, the answers to these questions are not entirely clear, but two conclusions may be reached with high confidence. First, given the massive easing already undertaken by the Fed and the likelihood of some further modest easing, the US economy now needs to undergo at least a near recession if the Fed easing is not to turn out as excessive. Second, if the Fed's highly aggressive actions have really been warranted to protect the economy from substantial harm, then, as Morris Goldstein will discuss, deep reforms of the financial system, including the Federal Reserve's own policies and practices, are clearly needed to reduce the likelihood of such problems in the future. The Federal Reserve cannot pose only as the hero riding to the rescue of the economy and the financial system. Its role as one of the villains whose earlier actions and inactions contributed to the present crisis needs to be fully and carefully assessed.