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Economic commentaries

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Downturn in the US – crisis or welcome moderation for the world economy?

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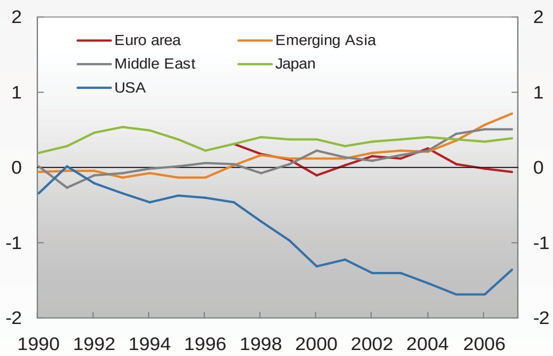
Problems in the US housing market triggered a surge in volatility in financial markets in 2007. Economic growth in the US has slowed markedly in recent quarters, with growing fears of recession. Given the size of the US economy, this will entail a decline in demand that will have a noticeable impact on the rest of the world. However, the global economy has so far been relatively resilient to the slowdown in the US. In spite of increased trade with the rest of the world, emerging market economies (EMEs) seem relatively robust to weaker exports. Growth in domestic demand remains robust in many of these countries, and there are growing signs of bottlenecks. Slower export growth may thus be a precondition for sustained solid growth in fixed investment and consumption in EMEs.

Global trade imbalances have grown over the past decade. While the US has been running large current account deficits, oil-exporting countries and a number of Asian countries, particularly China and Japan, have large saving surpluses. The euro area has seen a moderate surplus decline to around zero (see Chart 1).

In the US both households and the public sector have recorded considerable saving deficits. Since the mid-1980s, household saving has fallen and been very low in recent years. At the same time, housing investment was high in the first half of this decade. Low interest rates and new financial products contributed to fuelling housing demand. This led to a persistent rise in house prices, which made housing investment an attractive alternative and reduced homeowners' saving. Various factors can explain other countries' saving surplus. The surge in oil prices has resulted in sharp growth in export revenues for oil-exporting countries. In China, investment accounts for close to half of GDP, but given a very high level of savings there are still sizeable current account surpluses. In several other Asian countries, fixed investment has been low since the economic crisis in 1997-1998. The surplus countries' investments in US assets probably contributed to the low long-term interest rates in the US and thereby to prolonged period of rapidly rising house prices.

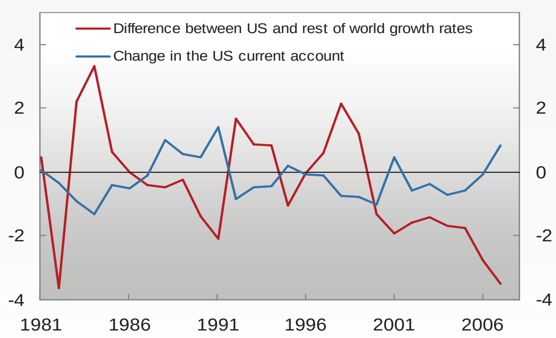
History has shown that large deficits on a country's current account balance will sooner or later have to be corrected either because financing becomes difficult or because domestic households and businesses do not want to increase their indebtedness further. Growth in the countries that is to reduce the deficit tends to slow in relation to growth among trading partners (see Chart 2). Normally, the real exchange rate depreciates ahead of and during the correction. The profile of the corrections varies from abrupt with severe problems to gradual with relatively few problems.[2] A sudden and pronounced correction of the large imbalances has been considered a downside risk to growth in the world economy for several years.

Chart 1 Current account balances. Per cent of global GDP. 1990 – 2007. Annual figures



Source: IMF

Chart 2 Difference between GDP growth rates of the US and the rest of the world and change in the US current account in percent of GDP. Percentage points. 1981 – 2007. Annual figures



Sources: IMF and Norges Bank

1 I would like to thank colleagues in Norges Bank Monetary Policy for many useful comments and input.

2 See IMF: World Economic Outlook, April 2007, Chapter 3 for a summary of many countries' deficit corrections.

In the case of the US, a correction in the housing market from the end of 2005 was the factor that triggered the slowdown in growth. In conjunction with the effects of a gradual depreciation of the US dollar over several years, this resulted in an incipient improvement in the current account[3]. This long appeared to be a gradual process, with relatively few problems for the rest of the world, partly because the slowdown in the US has been counteracted by strong growth in China, India and other EMEs (see Table 1). Growth in these economies has also resulted in an increase in their share of global GDP from 37.3% in 2000 to 43.7% in 2007. In 2007 growth in EMEs was record-high.[4]

Growth in the US has nevertheless slowed markedly in recent quarters.

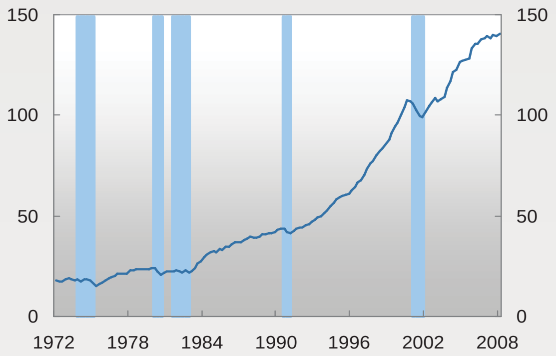
The US economy is of such a large size that changes in the US rapidly come into evidence in the global picture. Should, for example, US GDP fall by 1% this year (i.e. a 3.2 percentage point reduction in the growth rate from 2007), this will, all other things being equal, reduce global growth by close to 0.7 percentage point between 2007 and 2008. But all other things would not be equal. Some of the factors that are dragging down growth in the US are having an impact in other countries as well (financial turbulence, weakening housing markets and reduced confidence). Should the US shift into recession, US imports would also fall (see Chart 3),[5] and the US

3 The US current account deficit increased by USD 114.7bn in 2005 and declined by USD 72.8bn in 2007. This corresponds to about 0.4% and 0.2%, respectively, of GDP for the rest of the world at current USD.

4 In the 38 years covered by the data (from Figure 1.1. in World Economic Outlook, April 2008) growth has only once been as high (1973) as in 2007 in EMEs, and never higher.

5 In four of the five previous recessions, the volume of imports fell markedly. The fall was as much as 17.2% over the two quarters from Q4 1974, 14% over the two quarters from Q1 1980 and 7.6% over the four quarters from Q1 2000.

Chart 3 USA's imports in consant prices. Index, 2000 Q1 = 100. 1972 Q1 – 2008 Q1. Blue areras mark recessions



Source: Thomson Reuters

current account deficit would be reduced considerably. The rest of the world would then experience a sharp fall in demand.

Should, for example, imports weaken to the extent that the current account balance improves by 1.5% of GDP over one year[6], the decline in demand from the US will correspond to about 0.5% of GDP of the rest of the world or about 1.4% of GDP of all EMEs, at current USD.

There are already clear signs of moderating growth in Europe and Japan in the wake of the problems in the US economy, but growth still seems to be fairly robust in many EMEs. Whether global growth will remain robust during a recession in the US is to a large extent linked to developments in these economies. Even with optimistic assumptions for the other advanced econo-

6 This is approximately on a par with the improvement on the current account balance in 1991 when the US economy was in recession.

Table 1 Distribution of global growth[1)]

	World	Advanced economies		EMEs		
		Total	US	Total	Asia[2)]	Others
Percentage share of global growth past 10 year		41.9	17.8	58.2	33.2	25.0
Percentage share of global growth in 2007		30.4	9.5	69.7	39.4	30.3
Growth						
Average past 10 years	3.9	2.6	2.9	5.7	7.4	4.4
in 2007	4.9	2.7	2.2	7.9	9.7	6.3

[1)] Estimates based on GDP in USD terms at purchasing-power adjusted exchange rates.
[2)] The group Developing Asia in World Economic Outlook, which does not include former Soviet states or the Middle East.
Sources: IMF and Norges Bank.

mies, growth in EMEs will have to accelerate to avert below-trend growth in the global economy.[7]

Such a scenario seems unrealistic. EMEs have become more open in trade with other countries.[8] The immediate effect of weaker exports to the US will be slower growth. In addition, exports to other advanced economies will slow because growth will be lower in those economies as well. It is possible that a relatively sharp slowdown will also occur in many EMEs.

Even if some EMEs may be vulnerable to a sharp rise in oil and food prices, the main picture is that these countries are generally more robust to lower export revenues than earlier. As a result of improved economic fundamentals, the credit turbulence has had little impact on these countries. Many of the countries are running current account surpluses, have reduced external debt and built up foreign exchange reserves (see Chart 4).

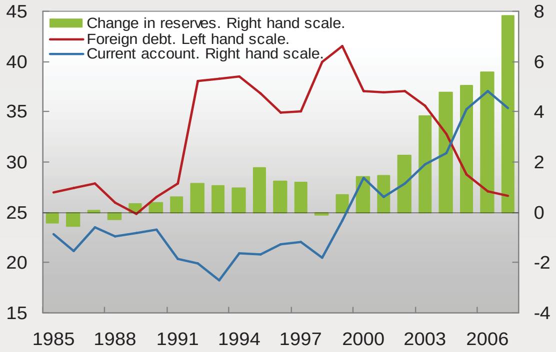
The last time Chinese exports weakened substantially, GDP growth remained relatively robust owing to the increase in domestic demand (see Chart 5).

Closer integration of EMEs into the world economy, and particularly China's membership in the WTO, implied an enormous increase in the supply of labour (and hence capacity)[9] in the global economy. This resulted in a subdued rise in prices for industrial commodities and kept inflation low for a long period in spite of vigorous growth in the world economy (see Chart 6).

The strong growth in EMEs also contributed to increased demand for oil and other commodities.[10] Combined with supply-side constraints, this has led to sharp price increases for most commodities. Domestic demand growth is still high in many EMEs. Inflation has increased and is now fairly high in many countries. Bottlenecks in both labour and commodity markets seem to be limiting growth even though there are still sizeable labour reserves in many EMEs. Slower export growth could provide room for sustained robust growth in investment in infrastructure and other domestic spending. If the supply of important commodities constitutes an effective constraint on global growth, weak growth in the US (or other advance economies) may be a precondition for continued growth in EMEs.

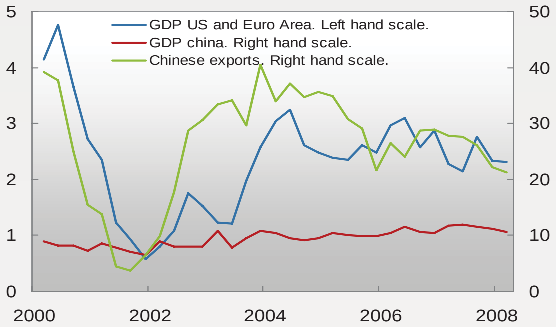
On the other hand, there is a risk that a downshift in growth in advanced economies and their imports will become so pronounced that it also triggers a cyclical downturn in EMEs.

Chart 4 Emerging and develpoing economies. Current account balance, foreign debt and change in foreign exchange reserves. Per cent of GDP. Annual figures



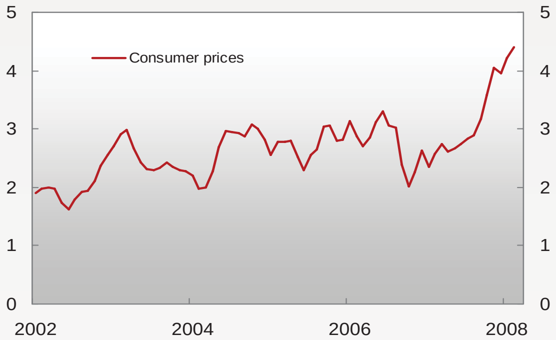
Source: IMF

Chart 5 GDP growth in G2 and China and export growth in China. Per cent change from the same quarter the previous year. 2000 Q1 – 2008 Q1



Sources: Thomson Reuters and Norges Bank

Chart 6 World consumer prices. Percent change from the same month the previous year. January 2002 – February 2008



Source: IMF

7 Trend growth is now 4.1% according to World Economic Outlook, April 2008. Assuming growth in the euro area is only reduced by half the average for the past 10 years, while growth is equal to the average for the past 10 years in other advanced economies and remains at the 2007 level in EMEs, global growth will be slightly weaker than trend growth. Should EMEs bring global growth up to trend, growth would have to accelerate from 7.9% to 8.3%. If growth in EMEs in this scenario is to be sufficiently strong to avert a fall in global growth from 2007, growth in these economies would have to increase to as high as 10.2%. In World Economic Outlook, the IMF projected growth at 3.7% this year, even with weak positive growth in the US.

8 For example, Chinese exports increased from 21% of GDP in 2000 to 37% in 2007 (Sources: Thomson Reuters and Norges Bank).

9 In World Economic Outlook, April 2007, the IMF estimated that the effective supply of labour in the global economy increased fourfold from 1980 to 2005, with the largest share of the increase occurring after 1990. The estimation was made by weighting different countries' labour force with exports as a percentage of GDP.

10 China alone accounted for 32% of the increase in oil demand in the period 2000-2007 Source: EIA). For aluminium, zinc nickel and copper, China accounted for 58% to 93% of growth in global consumption in the period 2000 – 2006 (Sources: Australian Commodities Statistics, World Copper Factbook 2007 and Copper Bulletin January 2003).

Irrespectively, global growth is highly likely to be weak in the coming years in the light of the weak growth prospects for advanced economies and the need for a growth moderation in EMEs in order to curb inflation. A key question is whether this will suffice to bring the surge in oil and other commodity prices to a halt or whether limited availability of these goods will lead to lower global growth for a longer period.