Global Economic Prospects

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Consensus forecast for the US

- At right you can see the latest IMF forecasts.
- The Fund sees the US growing by nearly 3% both this year and next, marginally better than the advanced country average.
- Q1 was weak at 1.8%. But this is dismissed as reflecting bad weather, Japanese supply chain disruptions, etc.

Table 1.1. Overview of the *World Economic Outlook* Projections
(Percent change unless noted otherwise)

	Year over Year			
			Projections	
	2009	2010	2011	2012
World Output[1]	**–0.5**	**5.0**	**4.4**	**4.5**
Advanced Economies	**–3.4**	**3.0**	**2.4**	**2.6**
United States	–2.6	2.8	2.8	2.9

How I differ from the consensus

- Recovery is slower from recessions that involve serious financial dislocations (crises) and involve structural change.
- And four problems continue to weigh on the consumer.

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First, the housing market

- Prices appear to be taking another leg down.
- New home sales are not picking up.
- And there are still waves of foreclosures coming onto the market.
  – Currently, half of all house sales are “distressed properties.”

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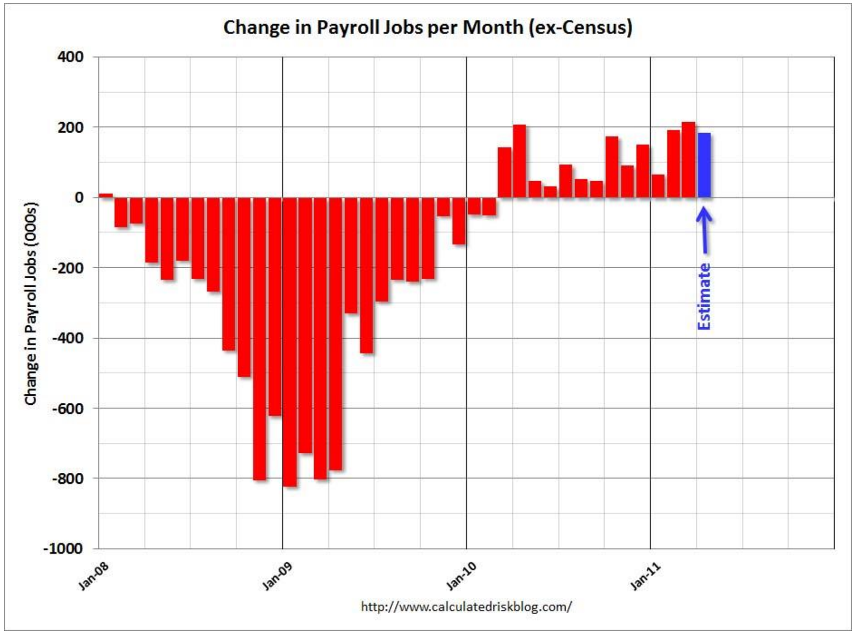
Second, unemployment

- Payroll employment is increasingly slowly with the recovery.
- 244,000 payroll employment growth in April.
- But you need 200,000 jobs a month just to keep the unemployment rate stable.
- At this rate, 6 years needed to restore full employment.
- Not much prospect, then of unemployment coming down unless this process picks up speed.
- Another way of looking at this is that in a normal recovery the US would grow at 4-5%; in this one it is doing barely 3%.
- 2.5% growth is needed to keep unemployment stable. 3% growth chops barely 1/4 % off the unemployment rate (by Okun's Law).



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Third, oil prices

- Prices are up $1, or 20%, since the beginning of the year.
- Recent data and analyses suggest smaller effects than earlier studies.
- Economies may have gotten better at substituting away from energy.
- The energy intensity of economic activity in the US is now declining.
- Central banks have learned to avoid second round effect (better monetary policy credibility).

Table 3.3.1. Annualized Percent Impact of a 10 Percent Oil Price Increase on Real U.S. GDP Growth after One Year

	GDP Peak Response (percent)	Sample Period
	Older Sample Period	
Rotemberg-Woodford (1996)	−2.00	1948–80
Hamilton (1996)	−0.75	1948–73
Blanchard-Galí (2007)	−0.40	1970–83
	Recent Sample Period	
Hamilton (1996)	−0.20	1974–94
Kilian (2009)[1]	< −1.00	1975–2007
Blanchard-Galí (2007)	−0.15	1984–2007
Cavallo-Wu (2006)	−0.40	1984–2007

Sources: Blanchard and Galí (2007); Cavallo and Wu (2006); Hamilton (1996); Rotemberg and Woodford (1996); and IMF staff calculations.

Note: The oil price series used may differ across studies. In all studies, oil price changes are meant to be induced by oil supply shocks and not driven by global demand.

[1]IMF staff calculations are based on Kilian (2009) results.

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Oil prices

- The main impact, in my view, is on consumer confidence. And in a car-happy economy like the US, that impact is decidedly negative.
- We tend to see sharp changes in consumer spending (consumers draw back, reducing spending on light trucks, other big ticket items) when energy expenditures exceed 6 per cent of consumer spending – a threshold we crossed in March.

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Fourth, state and local government spending

- State and local government spending fell at a 3.3% annual rate in Q1.
- This was a significant factor in the poor growth performance recorded for this quarter.
- This will almost certainly continue for the foreseeable future.

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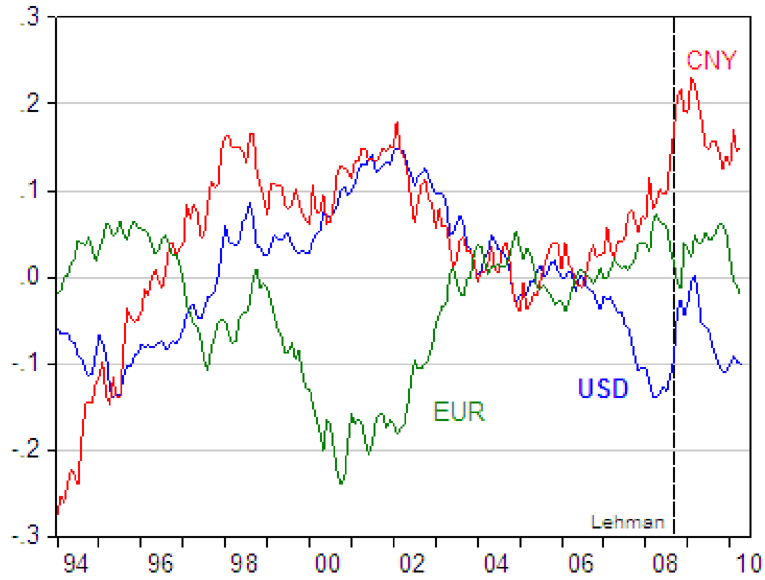
There are always exports

- The weak dollar helps.
  - I show the log broad *real* trade weighted dollar, at right.
- But ability to export also depends on growth in the rest of the world (to which I will come).



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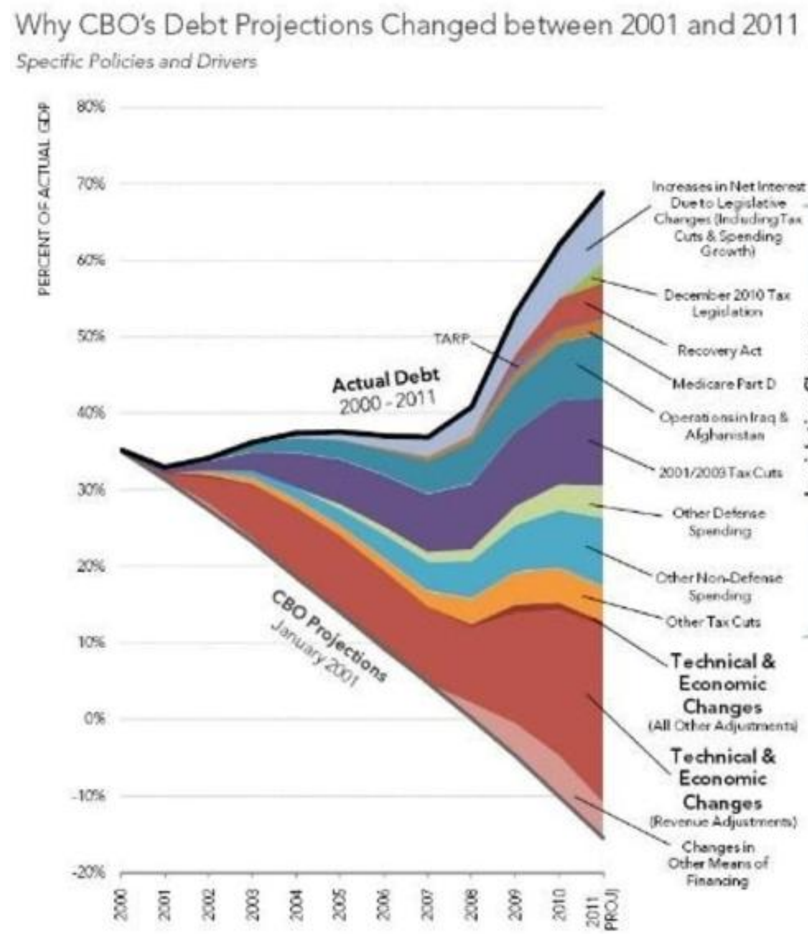
Medium term challenges

- Can be summed up in 3 words: It’s all fiscal.

A disappearing debt!

- This graph reminds you that once upon a time, not too long ago, serious people were worried about the US debt disappearing.



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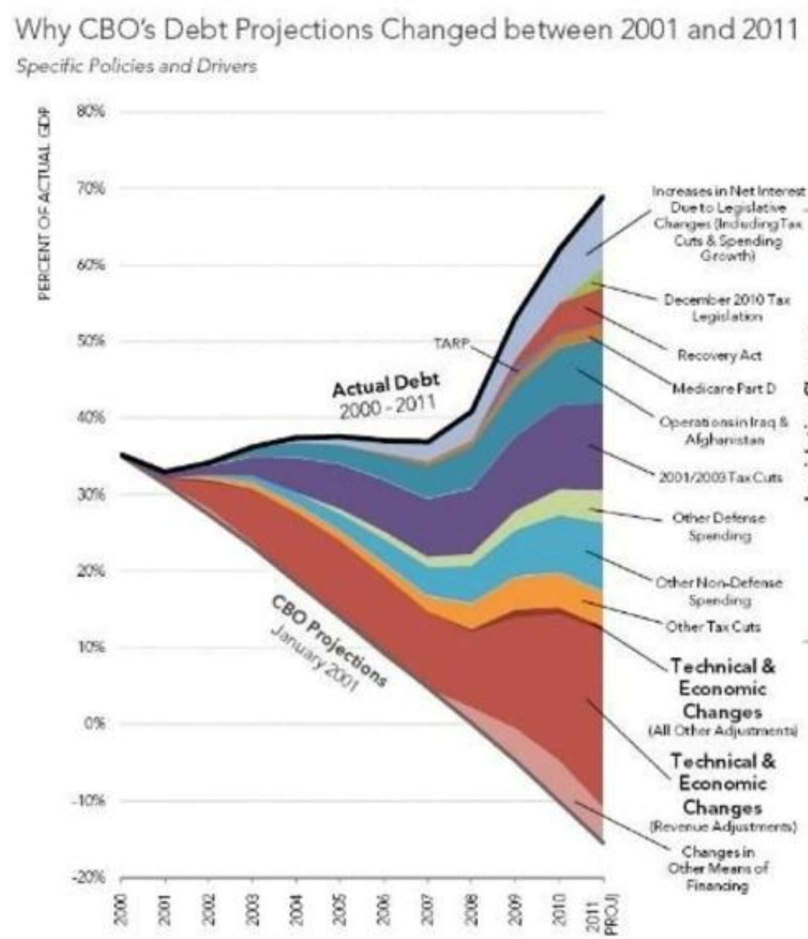
This graph also shows you the main drivers of the deficit

- It reminds that you can’t dig such a big budgetary hole through one action alone.
- The big red area is the revenue shortfall, much of which is due to the recession and crisis.
- Following this is the 2001-2 Bush tax cuts (in purple).
- Following this are operations in Iraq and Afghanistan.
- There is also a role for other new spending (prescription drug provision, for example).
- But other things like the 2009 Obama fiscal stimulus and the TARP are small potatoes.



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What effective medium term fiscal consolidation will require

- It will be necessary to do three things:
- A) Accept expenditure restraint.
  - The last slide showed that we *do* have a spending problem in the US, relative to trend – though it is not the largest part of the problem.
- B) Bend the health care cost curve.
  - Looking into the future, Medicare and Medicaid will become the largest contributors to the deficit.
- C) Raise revenue
  - As we saw in the last slide, the revenue shortfall due to tax cuts and recession has been the single largest contributor to the increase in the deficit.

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Will the US be able to do these things?

- It will have to.
- At some point, purchasers of Treasury debt will go on strike, and the bottom will fall out of the Treasury market.
  - Yields will shoot up, the dollar will crash.
- A good old fashioned crisis would then trigger action.
- What's my best guess of when this might happen? No one can say, but my best guess is 2013.
- It would be much better, of course, to get action without a crisis.

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Of course, the dollar is not the only currency with problems

- There is also the euro.
- We might ask ourselves: should these problems have come as a surprise?

It is not as if the Europeans were not warned

- Following the Nobel Laureate Robert Mundell (at right), they say a monetary union will work smoothly if it is an "optimum currency area." An OCA has:
  - Similar shocks to constituent economies.
  - Labor mobility between them.
  - Mechanisms for stabilizing fiscal transfers.
- Skeptics, already at the time, noted that Europe lacked all three.

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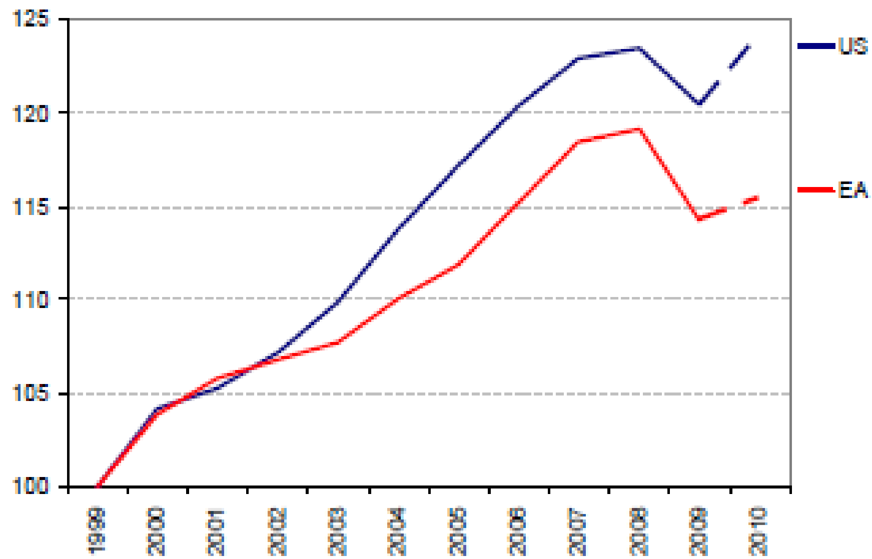
Yet the early evidence was reassuring

For example, growth was not all that bad

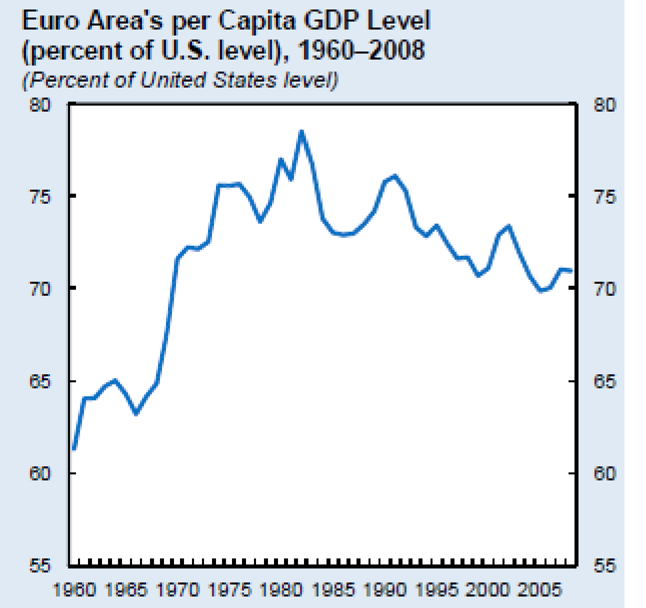
Euro area growth

Has been slightly slower than in the US



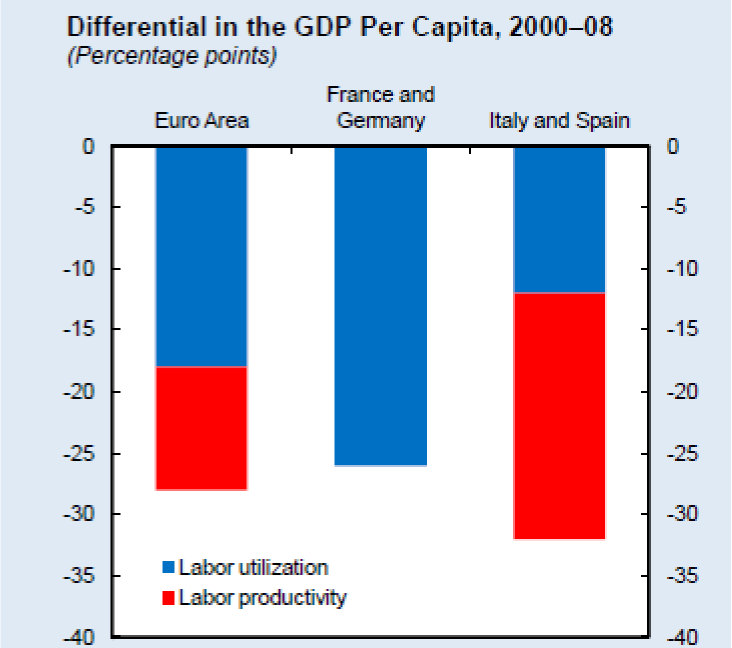
Real GDP (1999=100). Source: IMF and IMF projections (WEO, April 2010)

Europe continued to lag the US by measures like income per capita…



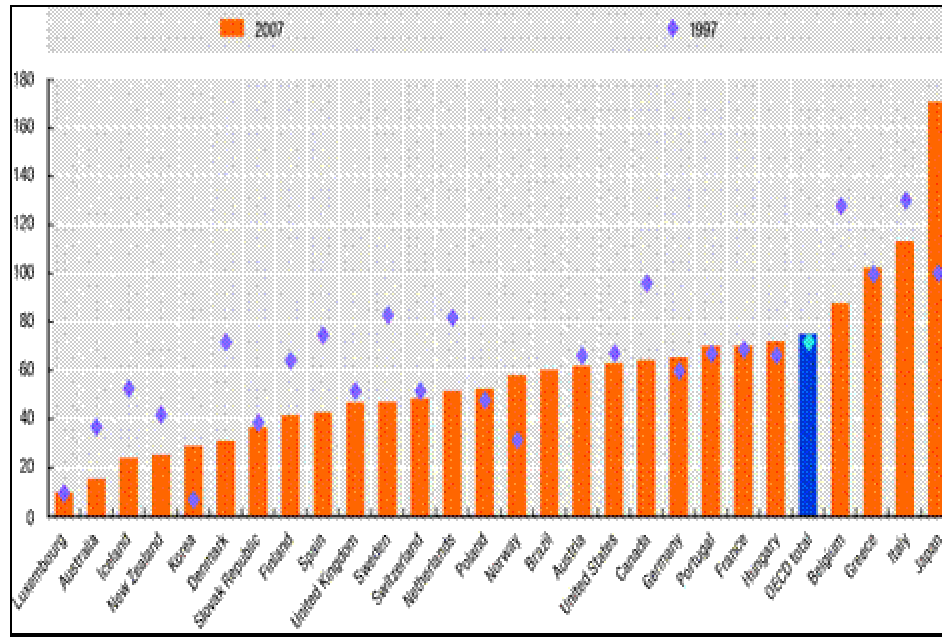
Source: AMECO database; European Commission; and IMF staff calculations.

…But this was less lower productivity than more leisure (a social choice)



Source: European Commission.

- While fiscal positions could have been stronger (notably in Greece), they were not so bad overall.
- Ireland and Spain, for example, ran persistent surpluses in the first half of the decade.



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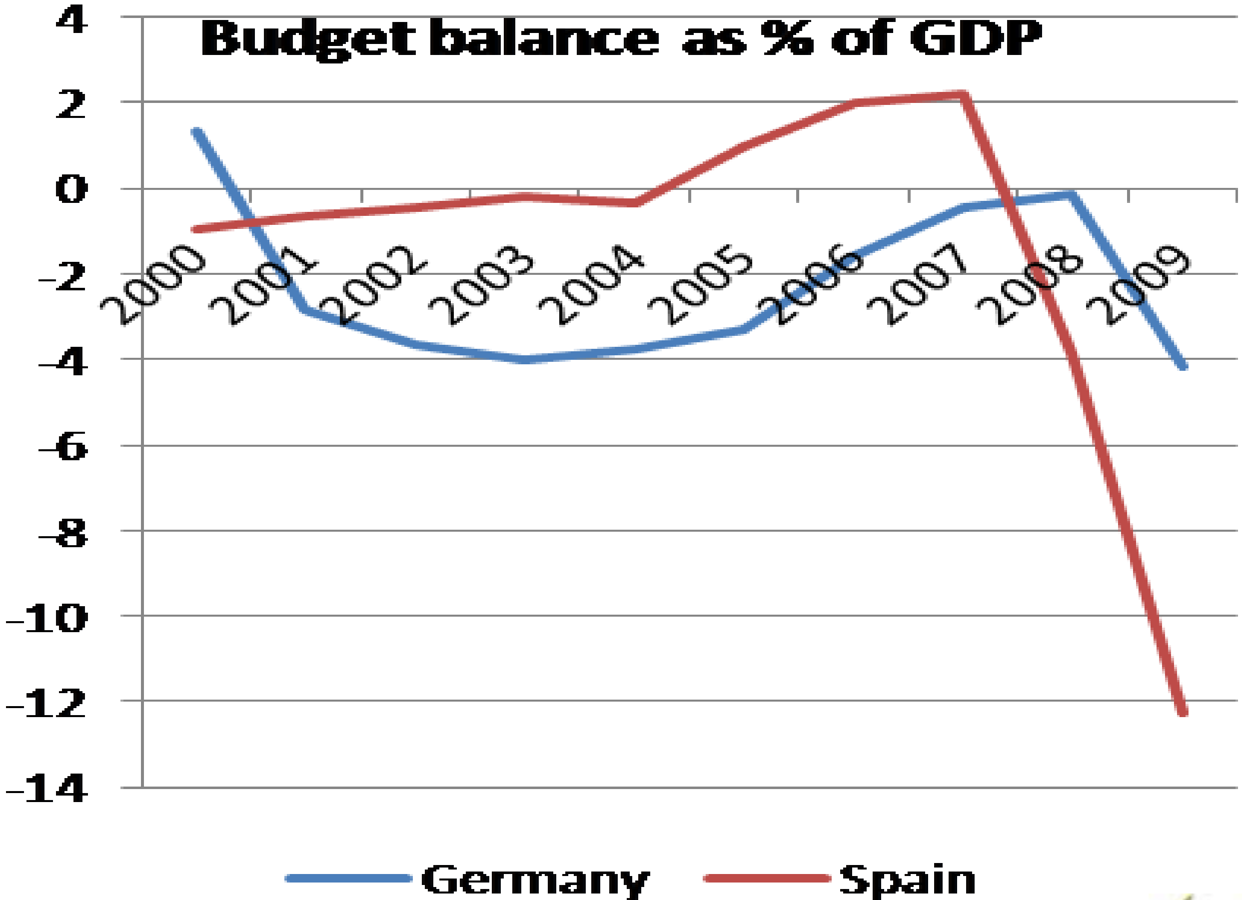
Who was the fiscally virtuous country before 2008?



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But there were problems lurking

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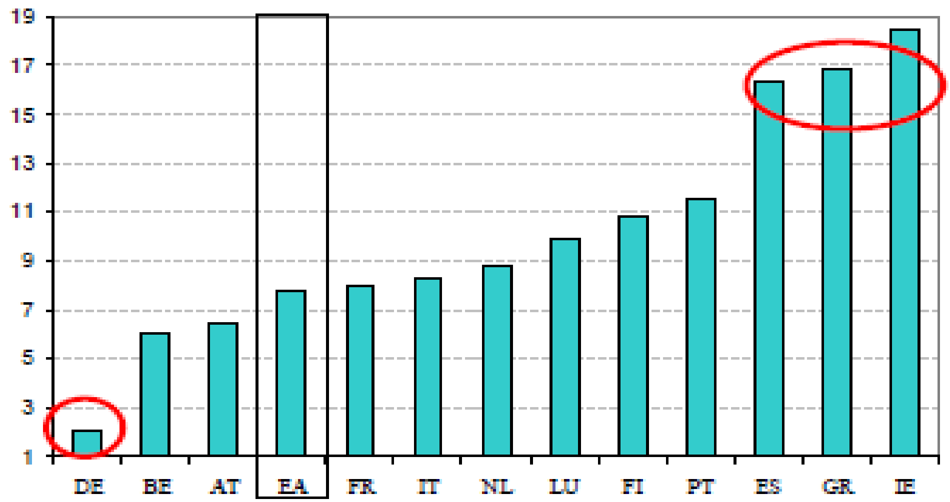
Some countries grew only as a result of big credit booms…

Fuelled by

Excessive credit growth in some countries…and very slow in others



Loans to the private sector (average 1999-2008) Source: ECB

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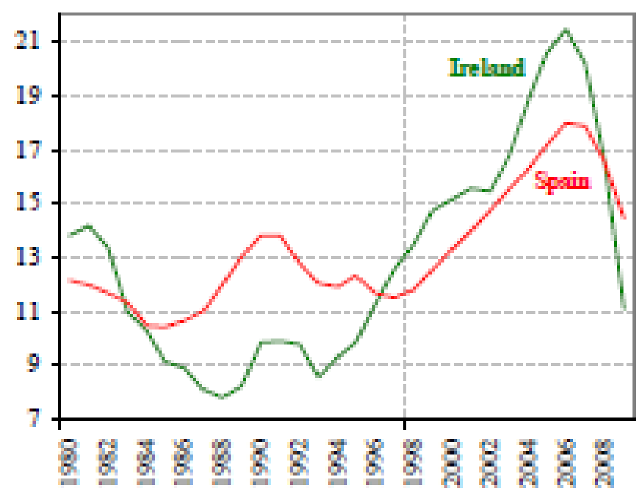
…Big credit booms that fueled bubbles

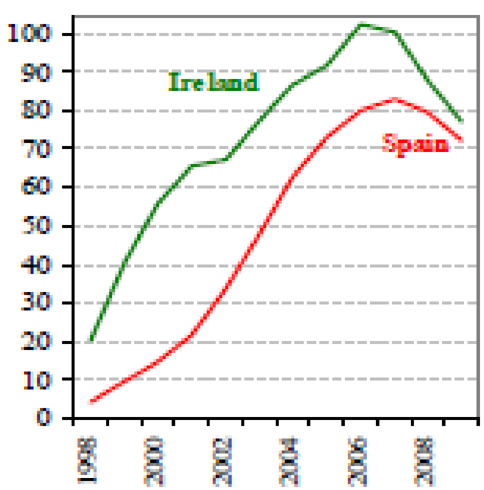
In particular in the housing market

Of some countries

Construction investment in % of GDP



Cumulated changes in real house prices



Source: Own computation on EC, ECB. Real house prices deflated with HICP

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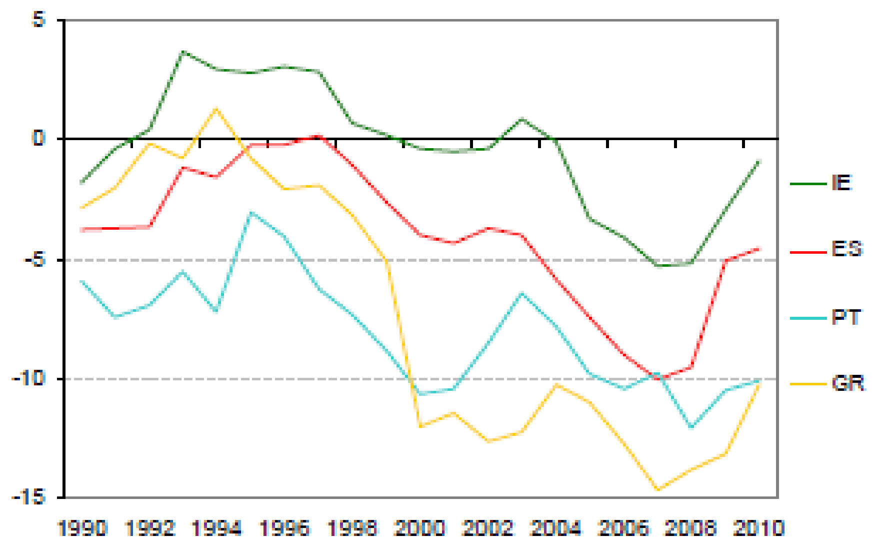
Often they financed this with foreign money (made possible by the perceived elimination of currency risk)

Producing deficits

In the current account positions of some countries



Current account in % of GDP. Source: EC. Note: 2010 is forecast (EC May 2010)

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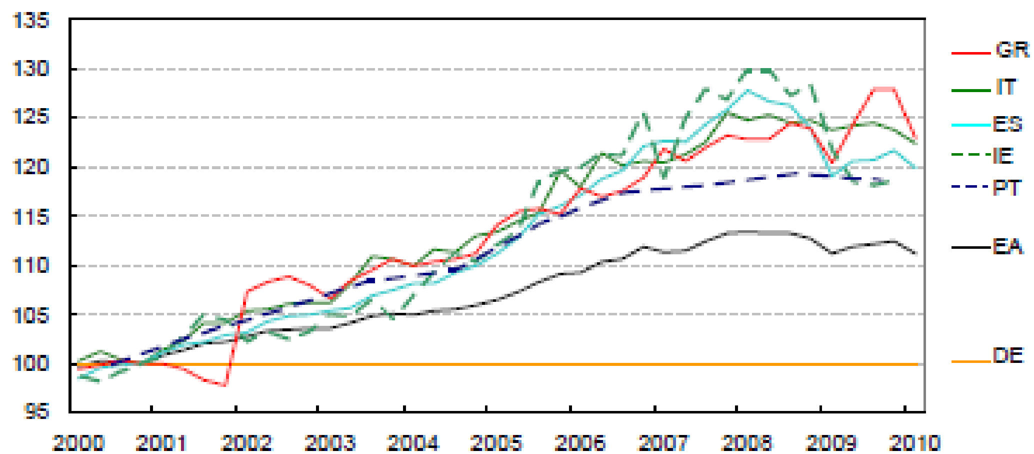
Some countries threw a big party, passing the good times through to wages, and failed to boost productivity

And divergences in cost competitiveness

Driven by excess growth of wages with respect to productivity



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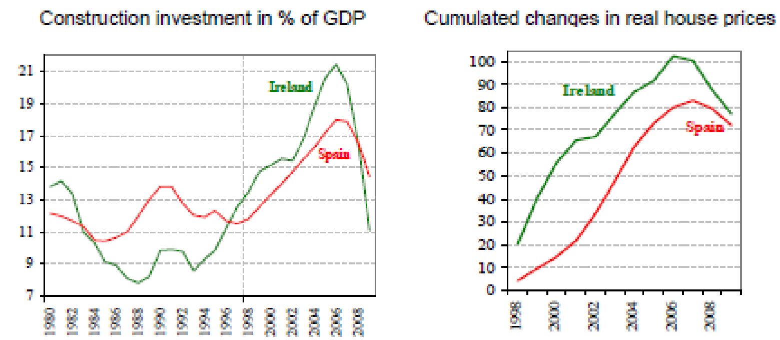
Competitiveness calculated on the basis of Unit Labour Costs, relative to Germany. 2000Q4= 100 Source: Eurostat.
Note: Quarterly data up to 2010 Q1 for Germany and Spain, 2009Q3 for Ireland and 2009Q4 for the other countries, except for Portugal which is based on annual data (up to 2009). Note: The ULC indices are set to 100 in the last quarter before the euro area accession of Greece. The ULC developments presentec for Greece and Portugal might differ from the calculations made by the National Central Banks. The quarterly pattern in Greek ULC is affected by substantial volatility in quarterly compensation of employees figures.

Then came the crisis

- Housing bubbles burst.
- Problems with banking systems were revealed.
- Strong budgets weakened.
- Governments attempted to mitigate the slowdown with fiscal stimulus (good) but indiscriminately (bad). In some cases, questions about fiscal sustainability therefore developed.
- In these countries, ability to borrow externally to finance their deficits was curtailed abruptly when investors abruptly awoke to these problems in early 2010.

In particular in the housing market

Of some countries



Source: Own computation on EC, ECB. Real house prices deflated with HICP

Fallout

- The combination of housing slumps, banking problems and weakness elsewhere (in the United States) would have produced a slowdown in any case.
- But doubts arose about fiscal sustainability, interest rates on government debt rose sharply in addition (at the worst possible time).
- The result was severe recession in the affected countries.

Source: Citi Investment Research and Analysis

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Governments were forced to respond with severe fiscal cuts

- Either that, or default on their debts.
- Which is not good for reputation (creditworthiness), much less appreciated by your citizens who hold government bonds.

Will it work?

Is there such a thing as expansionary fiscal consolidation?

- If fiscal sustainability is in doubt, fixing the problem may actually boost confidence and private spending.
- If the problem is too much public expenditure (not too little tax revenue), which is presumably the European case, then the composition of the adjustment also matters: confidence will be enhanced if the adjustment mainly takes the form of spending cuts.

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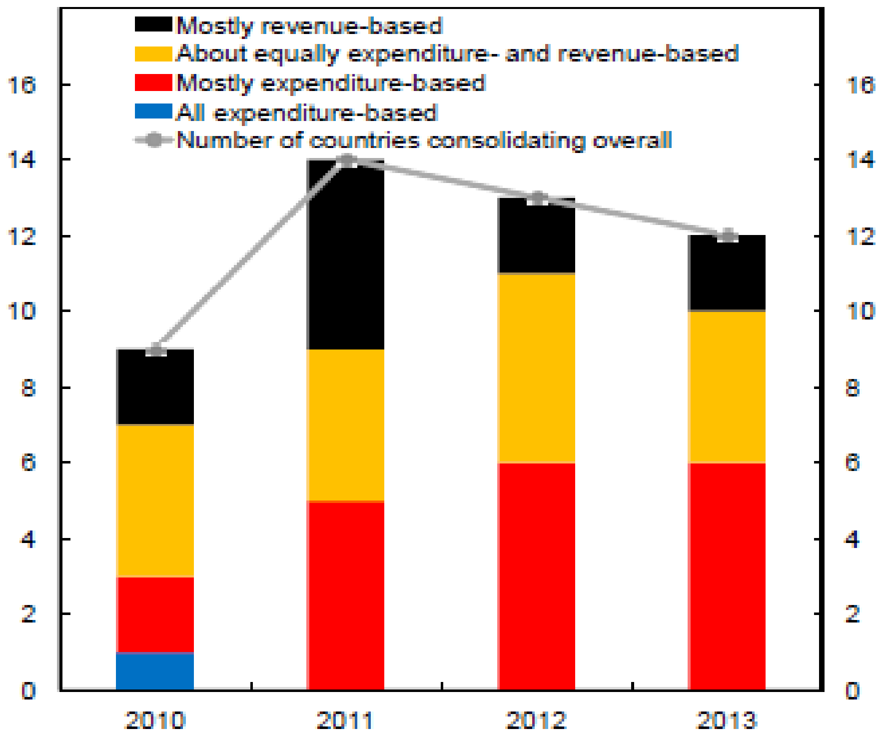
Composition is right

Bloated welfare states are mainly focusing on cutting spending

Figure 12. Euro Area: Structure of Expected Fiscal Consolidation, 2010–13
(Number of countries consolidating)



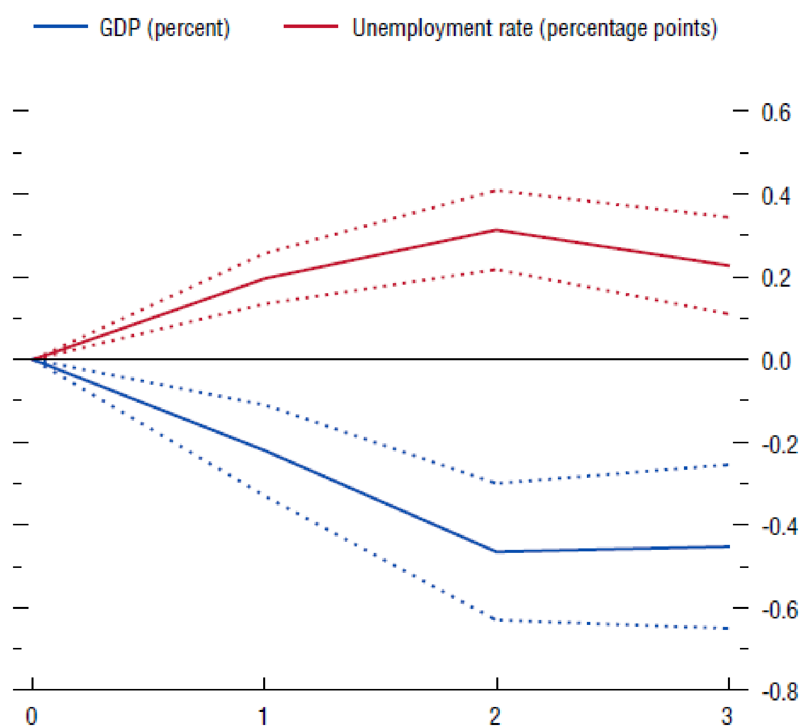
Source: IMF staff calculations.

But there is not just a confidence effect but also a direct demand effect

- With public-sector workers and pensioners receiving less, they are spending less.
- And this is not a positive.
- If less public spending is not offset by more private spending, growth slows.
- This is what the IMF concludes typically happens in your average fiscal consolidation episode.

Figure 3.2. Impact of a 1 Percent of GDP Fiscal Consolidation on GDP and Unemployment

Fiscal consolidation is normally contractionary. A fiscal consolidation equal to 1 percent of GDP typically reduces real GDP by about 0.5 percent and raises the unemployment rate by about 0.3 percentage point.



Source: IMF staff calculations.
Note: $t = 1$ denotes the year of consolidation. Dotted l
bands.

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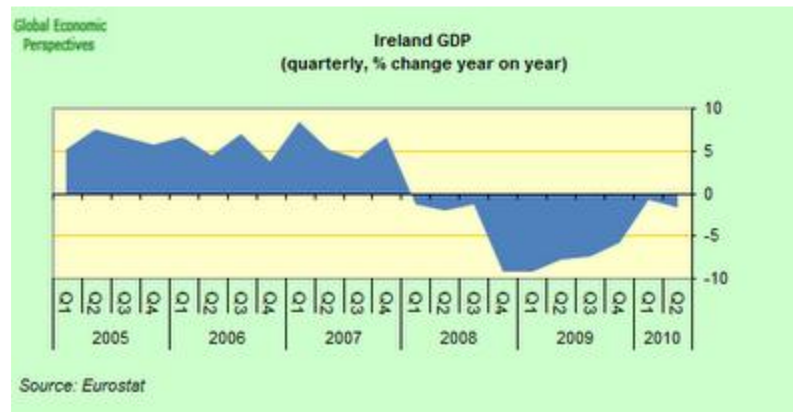
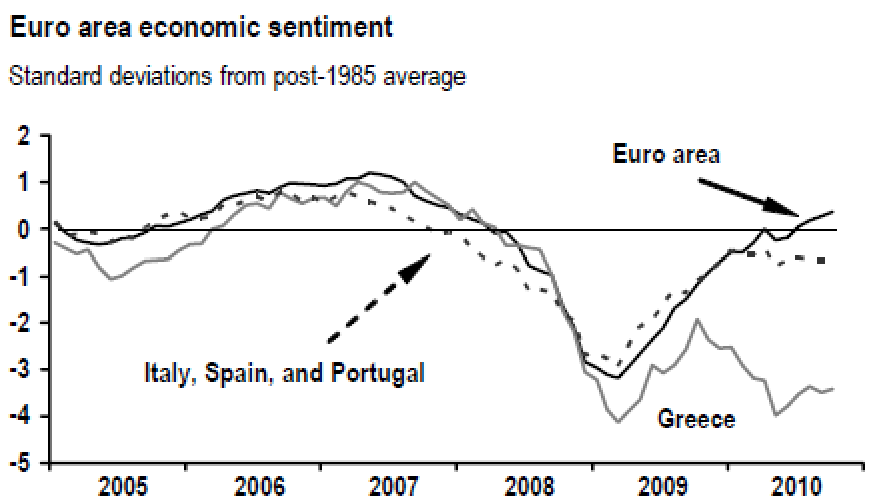
- Ireland, shown at right, is a case in point. Contrary to expectations, it still hasn't started growing again….
- Debts become heavier, not lighter, and sustainability remains in question.
- This is why I anticipate that the eventual resolution will involve debt restructuring.



You can see here how consumers in the affected countries are pessimistic



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So would these countries be better off without the euro?

- Greece, Ireland and others could depreciate their currencies, enhance the competitiveness of their exports, and replace domestic demand with external demand, buffering their recessions.
- Most successful fiscal consolidations in history have involved this.
- But does, say, Greece export enough for this to make a difference?
- Wouldn’t its borrowing costs also rise enormously?

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Why this question is, in any case, academic

- Abandoning the euro would be tantamount to abandoning the entire commitment to Europe integration (which is deeply ingrained).
- Technically, reintroducing a national currency is extremely difficult.
- In practice, it would provoke the mother of all financial crises.
- So it isn't going to happen.

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Germany is the one country that could reintroduce its currency without provoking a massive crisis

- No one would attack the “new deutschemark,” since it would be expected to appreciate against the euro.
- But this would destroy the German export miracle.
- And it would jeopardize the larger European project, to which Germany – lots of talk about a new generation of German leaders notwithstanding – is still committed.
- So it isn’t going to happen.

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- But to say that no member state will abandon the euro is different from saying that no member state will restructure its debt.
- Orange County can (and did) restructure its debt in 1994 without "leaving the dollar area."

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What Europe needs to do to complete its "common house"

- Strengthen *national* fiscal rules (and give the European Commission some oversight of such arrangements).
- Extent its multilateral surveillance from fiscal policy to other determinants of international competitiveness.
- Closely coordinate or even centralize bank supervision and regulation (the present "College of Regulators" being weak soup).
- Make its emergency financing mechanism permanent. Provide emergency fiscal transfers to countries with financing problems due to no fault of their own.

So far Europe has gone part way down this road

- Stability Pact has been strengthened again, placing emphasis on national fiscal rules. Will it work this time? We will see.
- Supplemented by Euro Plus pact to address other aspects of competitiveness.
- European Banking Authority created, but EBA lacks real authority.
- European Stability Mechanism, to come into existence in 2013, is underpowered and flawed in design.
  – In particular, making it work will require a "re-set" where debts are unsustainable.

Will these problems be fixed?

- Progress to date is not impressive.
- But every time Europe has faced a crisis and the decision of whether to go forward or backtrack, it has gone forward.
- My outlook being grounded in this history, I expect them to, once more, go forward.

- Thank you very much.

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