EVENT SUMMARY

Global Economic Prospects: Spring 2008

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

After four years of average annual growth of more than 4.5 percent, the pace is slowing in the major industrial countries, with the US on the verge of a mild recession. There is less of a slowdown in other industrial countries, and most emerging countries appear likely to maintain strong, albeit slower growth. Meanwhile, among both the industrial and emerging countries, inflation is mostly running above rates consistent with policy objectives.

In such a situation, Mussa is predicting a significant slowing of global economic growth, down to 3.8 percent in 2008 from 4.7 percent in 2007. This will be lead by a mild and brief recession in the United States, where real GDP growth in 2008 will fall to a rate of barely 1 percent, and moderately recover to 2 percent in 2009. Among other industrial countries, Mussa observes significant recession risks only in Japan and possibly Italy. The Euro-area is expected to expand in line with the potential, while moderate slowdown is projected for Canada and the UK.

While emerging-market economies will continue with quite strong economic growth, Mussa sees no strong indication of "decoupling". Countries particularly dependent on exports to the US (Mexico, Caribbean, Central America and Asian economies) will feel the effects of the US slowdown. Growth will slow in Latin America and Central and Eastern Europe, while Russia and other countries in the Commonwealth of Independent States should continue advancing strongly. High oil and commodity prices will aid economic performance in the Middle East and Africa respectively. China continues to surge forward, so much so that the authorities are tightening policies to cool down inflation, but Mussa reminds that the key policy step of currency appreciation has not been undertaken. Overall, developing and emerging-market economies as a group are forecasted to grow at about 6.5 percent this year and slightly slower in 2009, down from 7.5 percent in 2007.

Mussa views such developments as welcome, since they will help contain rising inflationary pressures and commodity price developments globally, and balance highly accommodative monetary policy domestically. The US economy is not crashing into steep recession, and with the benefit of the fiscal stimulus, it is expected to bounce back to moderately positive growth this summer. With the aid of rising exports that reflect the "reverse coupling", Mussa projects the growth to rebound to 2 to 3 percent during the second half of 2008.

Finally, Mussa emphasized that the key feature and source of uncertainty in the present economic situation is the continuing turmoil in the financial markets, especially in the United States. He sees financial markets and institutions themselves as mainly responsible for the crisis, which has sparked exceedingly aggressive actions by the Federal Reserve and (rightly) less aggressive actions of other leading central banks. Contrary to many financial-market commentators, Mussa argues that the Federal Reserve has not been "behind the curve" in its policy response. At this point it is not entirely clear if it overreacted to the credit market turmoil, unduly raising the risk of inflation, but Mussa concludes that given the massive easing, the US economy now needs to undergo at least a near recession to avoid higher inflation. Also, if the Federal Reserve's actions have indeed been warranted, then deep reforms of the financial sector, including Federal Reserve's practices, are clearly needed to prevent similar problems in the future.

Outlook on the Ongoing Subprime and Credit Crisis: Morris Goldstein

With subprime mortgages representing only 14 percent of the stock of US mortgages, most observers expected rising delinquencies in this segment to be contained at moderate cost of about $50-100bn. But the crisis proved to be wider, deeper, and more damaging then originally thought. By now worldwide credit losses just to subprime exposure have amounted to up to $200bn. Goldstein estimates that US banks, broker dealers, hedge funds and government sponsored enterprises will wind up with at least $300bn of credit losses on mortgage securities of all kinds. If that is expanded beyond mortgage securities, Goldstein notes that losses rise to the range of $600bn to over a trillion.

A second important characteristic of the crisis, Goldstein pointed out, involves the behavior of liquidity and credit spreads. These indicators have over the past eight months been highly volatile and have at times been much higher than anything we have seen in the past decade.

Further, Goldstein viewed the unprecedented injection of liquidity by the world's leading central banks, and especially the Federal Reserve, as the third distinct feature of the crisis.

Finally, contagion from the crisis to emerging markets has been less marked than expected, especially in comparison to earlier crises.

Goldstein summarized the present crisis management strategy by identifying five major elements: macroeconomic stimulus; large-scale liquidity injection; capital injections into weak institutions and enhanced transparency and disclosure; targeted assistance to housing sector; and more recently, beginnings of regulatory forbearance. He observed that while the administration has not run out of potential tools, the remaining available options are often extreme and unpalatable, or limited in potential impact.

As for what can and should be done for the crisis prevention in the future, Goldstein commented on the official sector's proposals before laying out his own ten-part reform strategy. While parts of recent official reports are thoughtful and helpful, Goldstein sees them as a disappointing response to a major regulatory failure. They are too timid, overlook some burning issues, rely too heavily on self-regulation of the financial industry, and focus too much on principles and not enough on precise benchmarks and rules.

Goldstein's own ten-part strategy includes orderly closure rules for large investment banks along the lines of what was established for banks with FedICIA (Federal Deposit Insurance Corporation Improvement Act of 1991); stronger national and international liquidity standards for banks and large investment banks, thoroughly reworked BAL-2 standards, with an emphasis on higher liquidity and capital requirements; separation of credit rating and consulting business at credit rating agencies to reduce conflict of interest; improvement cooperation between monetary and regulatory authorities during asset price bubbles so that both have accountability; inclusion of Wall Street compensation in risk management; tilting the growth of derivative market toward organized exchanges where systemic safeguards are stronger; reduction of bias for off-balance sheet items through correction of incentive structure; rationalization of US regulatory structure; and a reduction of US home foreclosures through legislative action.

Goldstein concluded that light-touch financial regulation is surely one of the causes of the crises, and does not increase the US competitiveness or economic leadership. It requires a comprehensive response, even if it may cause lower asset and profit growth within the financial industry, since it will reduce the risk of future crises.

Outlook for Emerging Asia and India: Arvind Subramanian

Subramanian stressed that the growing concern across emerging Asia has been inflation, which has gone above comfort levels for policy-makers, mostly on the back of surging world commodity prices. He estimated that it will be by about 1 percent higher in 2008 than previously expected.

Two policy responses to inflationary pressures were highlighted. In what he called “Reverse Mercantilism”, Subramanian pointed to a spate of actions to restrict exports and liberalize imports. He found this to be somewhat ironic, given the prolonged difficulties within the Doha Round in reducing tariffs on agricultural imports. On the macroeconomic side, there is little or modest evidence of tightening, and only a nascent willingness to allow currency appreciation.

As for growth forecast, Subramanian expects a moderate slowdown to about 8 percent in 2008 from 9 percent in 2007. The risks on the downside stem from a number of countries being highly exposed to trade, the fact that capital flows and “cheap finance” that fueled growth in last several years has recently been declining, and because rising inflation leaves less room for domestic-demand driven growth.

For India, Subramanian emphasized the political economy importance of inflation on elections which are coming up. This leads him to expect some currency appreciation and monetary tightening, due to which growth in 2008/9 may slow from 8.6 percent in last five years to about 7.5 percent.

Finally, Subramanian asked what the global effect of the new “competitive reverse Mercantilism” may be, suggesting that while each country’s action to restrict exports and stimulate imports may be individually reasonable, it can potentially be harmful by putting further upward pressure on world commodity prices. In that respect, he asked if export restrictions should not also find their way to the multilateral trade liberalization agenda.

Q&A

The Q&A session saw questions raised about whether the change in oil price would affect the forecasts, what the impact of Federal Reserve’s policy is on the position of the dollar, who will be taking the brunt of global demand slowdown internationally, and what sectors will be suffering the biggest contraction domestically, and why US equity prices declined less dramatically than in other markets.

The panelists emphasized that the part of the oil price rise is due to dollar decline; that the “dollar crash scenario” seems unlikely, but is overshadowed by longer-term trends in the US economy such as a decline in productivity and labor-force growth, which put risks for US competitiveness; that US current-account correction is a logical corollary of a decade-long opposite trend when it was mostly the US which propped global demand; that residential construction has already taken the biggest hit, but other may follow; and that US equity markets historically show less fluctuation than other markets.