World economy becoming more dependent on US debt

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The increasing fragility of the world economy is underlined by the latest report from International Monetary Fund staff on the position of the United States. The report, which will be the subject of discussion before a final document is prepared, said there was "general agreement" that the outlook for the US in 2005 and 2006 was "favourable" with gross domestic product (GDP) expected to expand at around 3.5 percent over the next two years.

Noting that the US had been the "main locomotive of global growth" in the recent period, the report said the US economy was again expected to outperform the other members of the Group of Seven major industrialised countries. Herein lie some of the major problems for the world economy as a whole because US growth is increasingly being supported by what the IMF report called "unprecedented borrowing" both from foreigners and domestically.

"This unusual constellation of financial flows has sustained growth by keeping long-term interest rates low and stimulating house prices. However, this creates a number of vulnerabilities, including the possibility of a marked slowdown of household spending, particularly were the housing market to cool."

The report went on to warn that "external imbalances"—the US balance of payments deficit now running at more than 6 percent of GDP and the inflow of funds from the rest of the world needed to finance it—posed a "significant risk" to the global economy. The US deficit is "widely viewed as unsustainable" and with limits to the global demand for US assets emerging at some point "there is a risk that an abrupt and disorderly shift in investor preferences could have an adverse effect on interest rates and global capital markets".

In other words, a sudden withdrawal by foreign investors from US financial markets would lead to a rapid rise in interest rates, a fall in the house prices, a decline in consumption spending and turbulence throughout the financial system, all of which would have far-reaching international repercussions, given the central role played by the US economy in maintaining global growth.

The IMF staff pointed to the "importance of US leadership" in implementing the G-7 "agenda for growth". The key challenge for the US will be to "achieve fiscal consolidation and higher national saving". This means that US spending, either by the government or consumers, must be reduced in order to cut back the US balance of payments deficit. But in the absence of significant growth in the rest of the world—the eurozone is close to stagnation while Japanese growth is largely the result of increased exports to China—a significant reduction in US balance of payments deficits will have a recessionary impact. In other words, maintenance of world economic growth requires sustained expansion in the US—the global locomotive—leading in turn to ever-greater deficits.

A recent policy note prepared by economist Wynne Godley for the Levy Institute highlights the problem. With US imports of goods and services now more than 50 percent higher than exports, and if growth continues at 3.5 to 4 percent per annum, "there will probably have to be a 12 percent annual average increase in the volume of exports sustained over four years (a growth rate rarely achieved in the past) to get any significant improvement in the overall balance".

The expansion of demand in the US has been "powered entirely by a renewed increase in private expenditure relative to income," which has been financed by a growth of debt. "Private debt has reached about 175 percent of private disposable income, another record, while net lending to the private sector rose from a trough of 8 percent of income in the third quarter of 2002 to more than 15 percent in the fourth quarter of last year."

The relationship between the expansion of financial markets, rising house prices, fuelled by low interest rates, and the overall stability of the economy was the subject of a speech by Federal Reserve Board vice chairman Roger Ferguson to a conference in Berlin on Friday.

Ferguson began his remarks by pointing out that "in terms of sheer volume, the expansion of financial activity has greatly outstripped economic growth in recent years." This had improved risk management, led to more efficient use of financial and real resources and boosted economic performance with "many observers" concluding that these financial developments were a "key factor in the strong productivity and growth that the United Stated has realised in recent years".

However, while economies had become more resilient, financial markets had become more sensitive with the result that "the past decade has been marked by episodes of financial volatility that have had the potential for trouble at a systemic level". The linkages between financial markets and the real economy had become more complex "periodically presenting policymakers with surprises and puzzles".

All of these issues, he continued, were contained in the movement of asset prices, particularly residential real estate. Because so many people owned houses, price changes, even when relatively small, could have a significant impact on the economy as a whole. "In a scenario of collapse, the damage to balance sheets and private wealth could go as far as undermining the soundness of the financial system and threatening the stability of the real economy."

While some economic commentators have blamed the Fed's low interest rate regime for creating a "bubble" in the US housing market—prices increased by 11.2 percent last year, well above the historical norm—Ferguson insisted there was not a clear relationship between expansion of the money supply and large increases in house prices.

But when the general level of interest rates was low, as is now the case, big increases in house prices could foster risky behaviour, including house buying in search of quick profits. "A concern is that changes in the underlying conditions that fostered this pattern or a policy misstep could cause a quick reversion to the historical norm." And with global markets increasingly linked, it was possible for big changes in asset prices in one market to "spill over into the markets of others".

The language was guarded because Fed Board members, taking their cue from chairman Greenspan, always strive to maintain an upbeat assessment. But Ferguson's remarks do point to concerns among financial authorities that the complexities of financial markets make policymaking much more difficult, with the increased risk of serious problems not only at a national level but on a global scale.