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Testimony of

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The Global Outlook

[1] The Council on Foreign Relations takes no institutional position on policy issues. All statements of fact and expressions of opinion contained in this testimony are the sole responsibility of the author. The author would like to thank Arpana Pandey and Paul Swartz of the Council on Foreign Relations for help with the preparation of the charts in this testimony.

The U.S. economy began to slow in late 2006, as home prices peaked and residential investment started to fall. The U.S. entered into a recession in 2008. However, much of the world economy remained, at least on the surface, healthy. Unfortunately, hope that the excesses of the housing boom could be unwound gradually disappeared last autumn. The extent of the global slowdown now underway is hard to overstate.

The latest forecasts suggest that in U.S. output contracted at a 5 percent annual pace, if not more, in the fourth quarter of 2008. That would be one of the sharpest quarterly falls in U.S. output in the last sixty years. Even so, the U.S. did substantially better than many other economies. The slowdown in most of Europe should be comparable to the slowdown in the U.S. Japanese output contracted at a 10 percent of GDP annual pace in the fourth quarter. Korean output contracted at a 20 percent of GDP annual pace. Chinese output growth was close to flat, but that implies a rapid deceleration in China's pace of growth. Commodity exporting economies are only faring better because they are still able to draw on the foreign assets they built up over the summer. Global output likely fell in the fourth quarter of 2008. The first quarter of 2009 looks similar.

Arresting this sharp fall in global output requires significant adjustments in policies. The Obama administration and the Congress are currently developing a stimulus package to support U.S. output as private spending and investment contracts. Further efforts to recapitalize the American financial sector are likely to be needed. Comparable policies should be adopted in all the major economies to halt the current, highly synchronized fall in global output.

This fall in global output has been accompanied by equally large changes in the pattern of global capital flows. In 2007, the total increase in the world's reserves exceeded $1.5 trillion, the total increase in dollar reserves exceeded of the United States current account deficit and central bank purchases of U.S. Treasuries easily exceeded the net issuance of marketable Treasuries. In the fourth quarter of 2008, global reserve growth came to halt. Falling commodity prices have reduced the external surplus of large commodity exporters and private capital is now flowing out of both commodity-exporting and commodity importing emerging economies. As a result, the majority of the Treasury's debt issuance in late 2008 was placed with private investors.

This is not a bad thing; the huge acceleration in reserve growth in 2006 and 2007 impeded necessary adjustments in the global economy—and allowed underlying vulnerabilities to build. A rise in the fiscal deficit that offsets a cyclical fall in private investment poses fewer long-term risks than a structural rise in the fiscal deficit than can only be financed by borrowing large sums from the rest of the world.

My testimony will focus less on the U.S. outlook than on the tremendous shifts now underway in the global economy, as a period of expanding trade gives way to a sharp contraction and as the pattern of capital flows that defined the global economy over the past several years reverses itself. It is organized in three sections:

The first briefly reviews the state of the global economy. The second looks at the latest trade data. The third examines recent changes in the pattern of capital flows.

A truly global contraction

The IMF currently forecasts that global activity will expand by 0.5percent in 2009—down from in 3.4 percent 2008 and 5.2 percent in 2007. Ongoing, though more subdued, growth in large emerging economies would offset a synchronized contraction in the U.S. Europe and Japan. This forecast, alas, may still be too optimistic.

The current forecast is significantly more pessimistic than IMF's forecast in November, as activity slowed faster than anticipated in the U.S., Europe, Japan and Russia (Figure 1). However, it still likely overstates growth in the world's emerging economies. A few facts are illustrative:

-- The fall in Korean output in the fourth quarter of 2008 (q4 2008), annualized, is comparable to the fall in output that accompanied Korea's crisis in 1997-98. Singapore and Taiwan have posted similar falls in output.
-- The deceleration in China's growth in the fourth quarter of 2008 almost certainly exceeded the deceleration in China's growth in the Asian crisis, or the global electronics slump of 2000-2001. The IMF's forecast of 6.7 percent real growth looks optimistic..
-- Leading indicators imply a larger fall in Russian output than in Russia's 1998 crisis. The IMF is now forecasting Russian output to contract in 2009.
-- Similar indicators suggest that Brazil, which entered into the crisis in far stronger financial shape than it entered into past global downturns, will also experience a sharp contraction.
-- Almost all Eastern European economies that relied on large net capital inflows (generally from European banks) to finance large current account deficits are either in a recession or poised to enter one.

In most respects, the deceleration in the growth of the emerging world now looks sharper than the deceleration in the U.S. and Europe. An outright fall in global output—a mark of an unusually severe global contraction—looks increasingly likely.

The obvious risk is that bad news compounds: The initial fall in output gives rise to a further falls in investment, employment and consumption—dragging growth down further. The only bright spot: the synchronized global slowdown leaves little doubt about the needed direction of the global policy response.

An enormous contraction in trade

One of the quirks of the global economy is that different nations release data on their exports and imports on a different time scale. December data is now available for all the large Asian economies, but not for the U.S. or the EU.

Usually this doesn't matter much; trade flows tend to adjust gradually. But in this case the Asian data points to a ferocious—and I use that word intentionally—fall in both intra-Asian and global trade. Taiwan's year-over-year (y/y) exports were down over 40 percent; Japan's exports were down 20percent, Korea's exports were down close to 20percent and China exports were down 3percent—better than the rest of Asia but still a major deceleration from the 19percent growth registered in October (Figures 2 and 3). The fall in Korean and Taiwanese exports augers further falls in China's exports, as China imports electronic components for final assembly. It also provides indirect evidence of a sharp slowdown in China's own demand.

Asian imports are down too, in part because of the fall in commodity prices. China's current account surplus is up, as the 20 percent y/y in fall in imports topped the fall in its exports. In Japan, though, the fall in exports topped the fall in imports leading Japan to post its first current account deficit in a very long time. That illustrates just how rapidly the global economy is changing.

European data isn't more encouraging. The sharp slowdown in the UK and Spain suggest a contraction in demand from Europe's large deficit countries. The slowdown in Russia and Eastern Europe will certainly feed through to Europe's exporting core German exports were down 9percent in November (Figure 4).

These contractions matter for the U.S. for two reasons. First, the fall in Asian exports likely reflects a sharp fall in U.S. demand for Asia's output—and thus provides indirect evidence of the scale of the slowdown in U.S. demand. Second, the fall in global activity, especially in conjunction with the dollar's recent rally, suggests that the U.S. should anticipate a sharp fall in its exports. November exports were down 2percent (Figure 5). West Coast outbound container traffic is down substantially more in December and January – as are leading indicators of export demand (Figure 6). It would be surprising if U.S. exports didn't fall by close to 10 percent in the December, and by even more in the first quarter.

For the past several quarters, U.S. non-oil exports have grown substantially faster than U.S. non-oil imports, bringing the non-oil deficit down. The expansion of net exports associated with the improvement in the real trade balance was a key reason why the decline in residential investment didn't produce a bigger fall in economic output. The overall trade deficit though remained roughly constant, as the improvement in the non-oil balance was offset by a rise in the United States petroleum import bill.

The recent fall in commodity prices points to a significant improvement in the U.S. trade balance. On current trends, the January deficit could be as low as $30 billion—roughly half its peak level. As a result, the United States' need for large net capital inflows from the rest of the world is falling not rising—a point that I will return to.

The sustainability of this improvement depends on the long-term trajectory of oil prices—and the evolution of non-oil export and imports. That in turn depends in large part on whether the rest of the world joins the United States in taking strong steps to support domestic demand growth—or whether they opt instead to support their exports and rely on the reemergence of U.S. demand. The more the world does to help itself, the more it well help the U.S.—and help to limit the reemergence of macroeconomic imbalances.

A reversal of global capital flows

The pattern of global capital flows over most of the past eight years was defined by:

-- An expansion of private flows between the U.S. and Europe, with an especially large increase in private flows to and from the UK. These flows generally balanced.
-- An increase in U.S. and European demand for the financial assets of the emerging world. This increase was particularly pronounced after 2006. Broadly speaking, when the U.S. slowed and emerging economies didn't, private investment sought out higher returns in the fast-growing emerging world.[2]
-- An enormous increase in the foreign assets of emerging market central banks and sovereign funds. In the four quarters from mid 2007 to mid 2008, the governments of the emerging world added over $1.5 trillion to their foreign assets; the increase in their dollar asses likely exceeded the U.S. current account deficit. This reflected the China's growing current account surplus, the concurrent rise in oil prices and strong private

[2] To simplify, I have left out the yen carry trade. This no doubt was significant. Japanese retail investors and foreign hedge funds alike borrowed in low-yielding yen to buy higher yielding currencies. This helped push the yen down against many European currencies. It also generated significant inflows into countries like Australia. However, Japan's current account surplus though generally has been constant. The main change in the world economy, on a global level, was the expansion of the surplus of China at the same time that high oil prices pushed up the surplus of the oil-exporting economies

capital inflows to the emerging world. As a result, emerging market governments were a large source of net financing for the U.S. and Europe.

The scale of all these flows was unprecedented. Net private capital outflows and inflows from the U.S. peaked at around 15percent of U.S. GDP in mid-2007 (Figure 7). The IMF's data indicates that (net) private inflows to emerging economies rose to $600 billion in 2007 and the first part of 2008, a sum well in excess of the large inflows that preceded the 1997-1998 Asian crisis. Emerging market reserve growth increased by a factor of about ten from 2000 to mid-2008, rising from $150 billion to an estimated $1300 billion at the end of 2007, with an additional $200 billion or so increase in the foreign assets of their sovereign funds (Figure 8) Taking into account the Treasury and agency bonds that central banks purchased through intermediaries in the UK, total central purchases of Treasuries and Agencies were comparable in scale to the U.S. trade deficit over most of 2007 and 2008 (Figure 9).[3]

Each flow has now gone into reverse.

Cross-border flows across the North Atlantic started to contract last August, when the subprime crisis first highlighted the risks of buying complex securities. These flows are now negative. Private U.S. investors are selling their foreign assets. U.S. banks are lending less to the rest of the world. And private investors abroad are selling their U.S. portfolio. Much of the expansion in these flows, in retrospect, seems to have been associated with the growth of the "shadow" financial sector: unregulated institutions that issued short-term securities to buy long-term securities were often formally based in Europe even though they sold their debt predominantly to American investors and primarily bought long-term U.S. securities.[4]

Private capital is now flowing out of the emerging economies. The pace and scale of this reversal has been comparable to the reversal that accompanied the 1997 emerging market crisis. Over $100 billion of private capital left Russia in the fourth quarter of 2008; the outflow from China likely was similar. Those emerging economies with large reserves are now drawing on those reserves to offset private outflows; those emerging economies with smaller reserves have turned to the IMF and others for crisis financing.

[3] The monthly TIC data tends to understate both Chinese and central bank purchases of U.S. bonds. The annual survey of foreign portfolio holdings of U.S. securities tends to revise the UK's estimated holdings down substantially, while revising the holdings of central banks, China and the Gulf up. My estimates use the pattern of past data revisions to provide a closer to real-time estimate of central bank demand for U.S. assets. For more, See "China's $1.7 trillion dollar bet," Center for Geoeconomic Studies Working Paper #6 (Council on Foreign Relations: New York)

[4] European banks that borrowed in the wholesale market to buy long-term U.S. securities had similar effect on the data – and played a similar economic role.

Central bank demand for U.S. financial assets is also poised to fall. The New York Fed's custodial data suggests a drop in (net) central bank demand for U.S. assets in December and January. This decline, though, hasn't been as sharp as the decline in the overall pace of reserve growth. Data that I track with Christian Menegatti of RGEMonitor suggests that global reserve growth stopped in the fourth quarter (Figure 10). The fall in central bank reserve growth has coincided with a massive change in the composition of reserve portfolios: Central banks are shifting from risky private fund managers and custodians to the safety of the New York Fed, and from agency bonds (Fannie Mae, Freddie Mac, Ginnie Mae) to Treasuries (Figure 11 and Figure 12). Central bank demand for Treasuries reached record levels in the fourth quarter despite the sharp slow-down in central bank reserve growth.

Even so, the rise in central bank demand for Treasuries was far smaller than the increase in Treasury issuance. As a result, central banks absorbed a much smaller share of the Treasury's total issuance in 2008 than in 2006 or 2007. For the first time in many years, the majority of the net issuance of Treasury bills and notes was absorbed by private investors, including private investors in the U.S. (Figure 13).

Looking ahead

The surprises of the last year require treating any forecast with caution. Even those who predicted that large losses in home lending would lead to a crisis in the U.S. banking sector and a sharp slowdown in the U.S. and global economies didn't expect that a crisis that originated in the U.S. would lead the dollar to rally. It would be a surprise if an unsettled global economy followed a predictable course in 2009.

The next few quarters likely will be marked by a transition to a lower level of trade, a lower level of cross-border flows and, unfortunately, a lower level of economic output. Forecasting whether non-oil imports will fall faster than non-oil exports is hard. The only easy forecast is that the fall in the price of oil will tend to improve the current account balance of all oil-importing economies. The already observed fall in oil prices would—barring an offsetting contraction in U.S. exports to the oil producing economies—bring the U.S. current account deficit down to between 3 and 4 percent of U.S. GDP (well below its peak level of around 6 percent of U.S. GDP).

It is also likely that the pace of reserve growth will remain subdued. The fall in the pace of global reserve growth in the fourth quarter primarily reflected both large capital outflows. Banks withdraw credit from most emerging economies, hedge funds scaled back their bets on emerging market equities and Asian investors reversed their bets on the RMB's rise. If global financial conditions stabilize, the pace of these outflows should fall. Reserve growth then would converge with the emerging world's current account surplus. That surplus though should fall, largely because of the fall in the price of oil and other commodities. Even if reserve growth bounces back from its current lows, it won't reach its past highs. The slowdown in global reserve growth implies—once the current reallocation existing reserves toward Treasuries is complete—a decline in central bank demand for Treasuries. The People's Bank of China will not continue to buy $150 billion of Treasuries a quarter.

As a result, the 2009 expansion of the U.S. fiscal deficit will not be financed by an increase in the United States' net borrowing from the rest of the world. The growth in the fiscal deficit, at least in 2009, is likely to offset a significant rise in the net savings of the U.S. private sector. Merrill Lynch and Goldman Sachs are both forecasting a fall in private consumption that will push the U.S. household savings rate up even as private investment falls. This will free up domestic savings to invest in Treasury bonds.

These forecasts are based on the assumption that the enormous shocks the global economy has experienced over the past six months will continue to produce enormous swings in the pattern of activity globally. It is possible that the downturn in private consumption and investment won't be as large as forecast, and a large stimulus will end up putting pressure on the United States external deficit. But it is also possible that the downturn will be more severe. Recent economic data—especially those from outside the United States—has been far worse than expected.

The sustainability of the fall in the U.S. external deficit ultimately depends as much on the policy response of other countries as on the actions of the U.S. government. The more other countries can do to generate internal demand, the more support they will offer the global economy. Others countries stimulus plans will spillover into demand for U.S. exports, just as the U.S. stimulus will spillover into demand for the exports of the rest of the world. Conversely, if the U.S. ends up doing most of the heavy lifting to support global demand, the U.S. recovery will be weaker and likely be associated with a renewed rise in the United States' external deficit.

The scale of the issuance of Treasuries associated with the need to support U.S. demand and finance the necessary recapitalization of the financial sector is shocking. But so too is the scale of the recent downturn in U.S. —and global—activity. The risk of doing too little remains larger than the risk of doing too much. That is true for the U.S. It is also true for the world's other major economies.

Figure 1: U.S. purchasing managers survey (ISM) signs sharp decline in activity

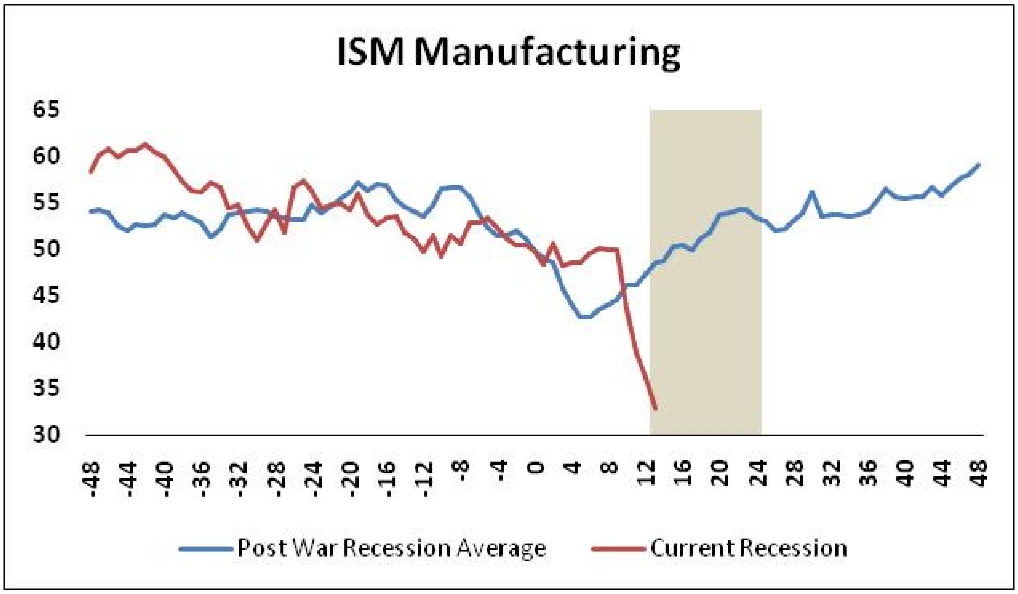

Figure 2: Asian exports (y/y change in $ billion)

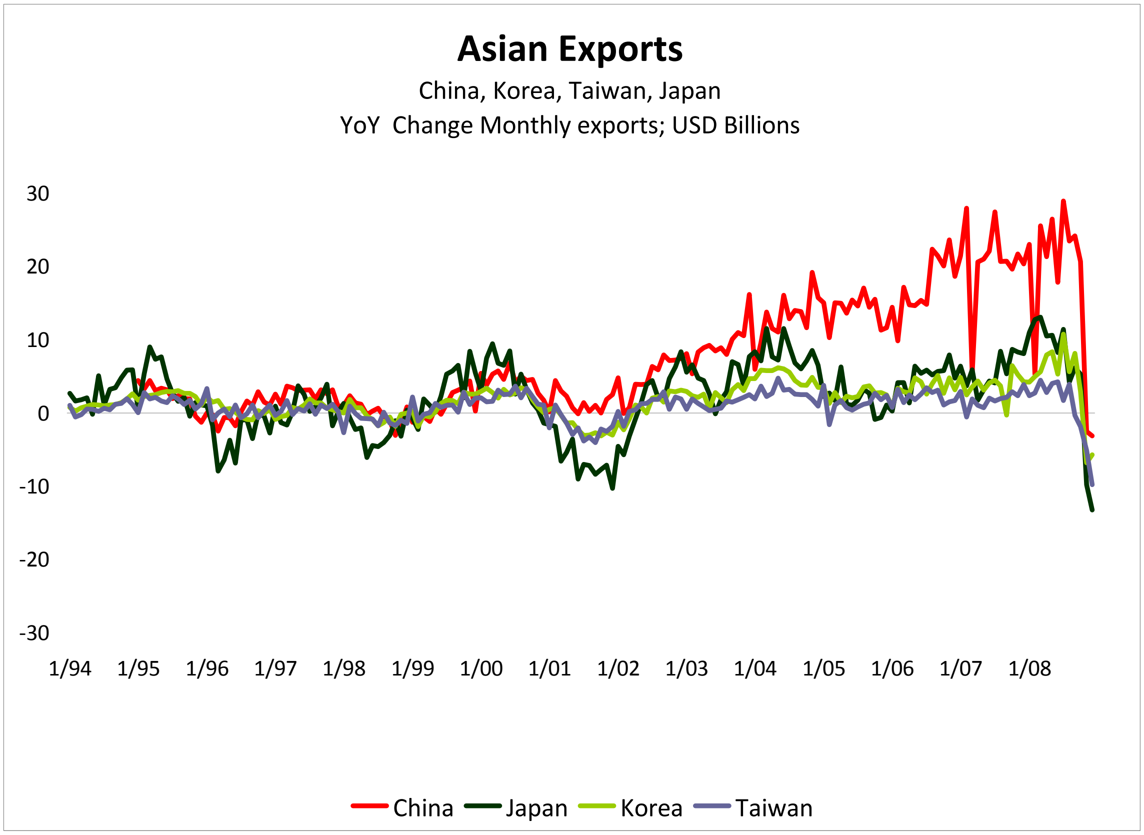

Figure 3: Asian exports: y/y percentage change, national data

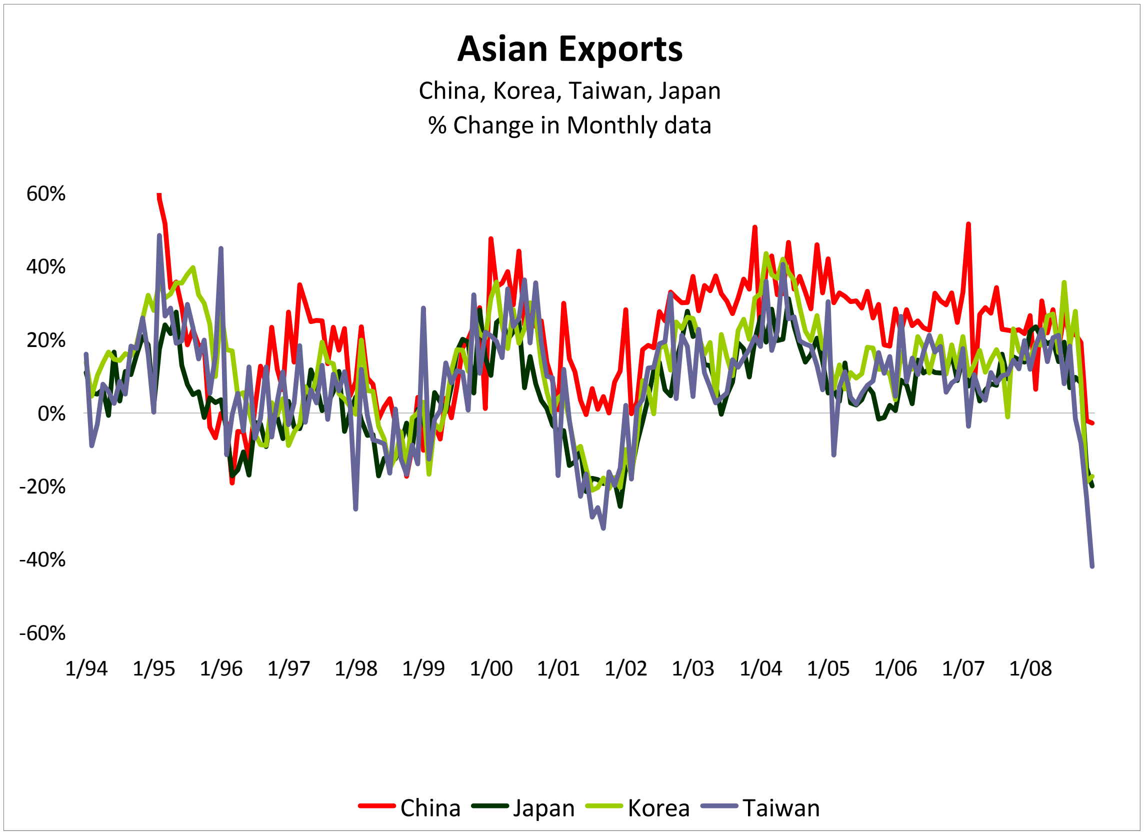

Figure 4: German exports: y/y change, in euros billion

Figure 5: y/y percent change in U.S. non-oil export and import growth.

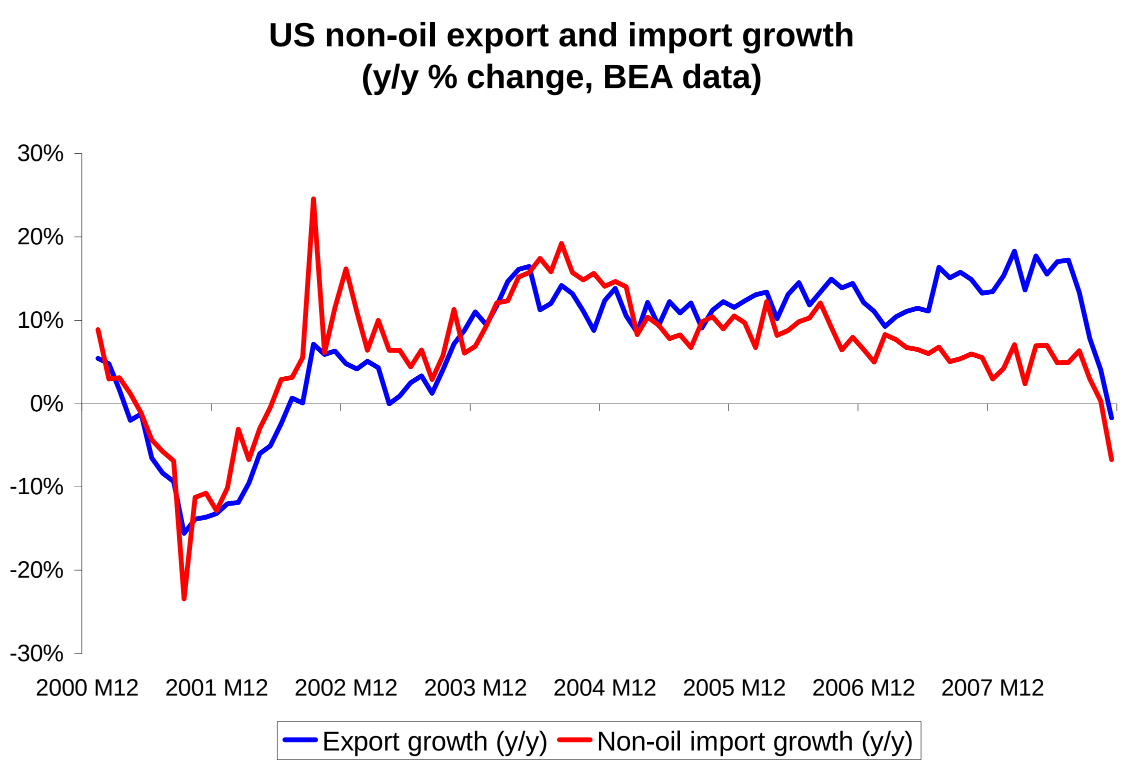

Figure 6: ISM export orders

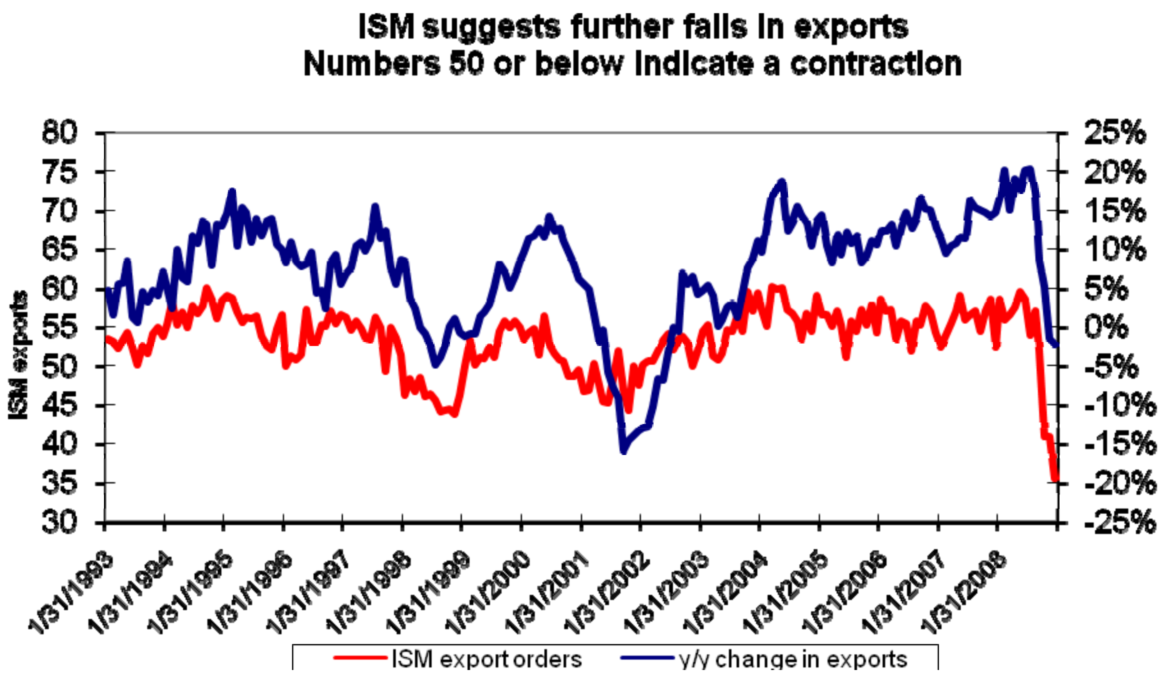

Figure 7: Private capital inflows and outflows. U.S. BEA data. Treasury purchases have been subtracted from private inflows from q3 2007 to account for likely future revisions (in the past, these purchases have been reattributed to the official sector in the revised data).

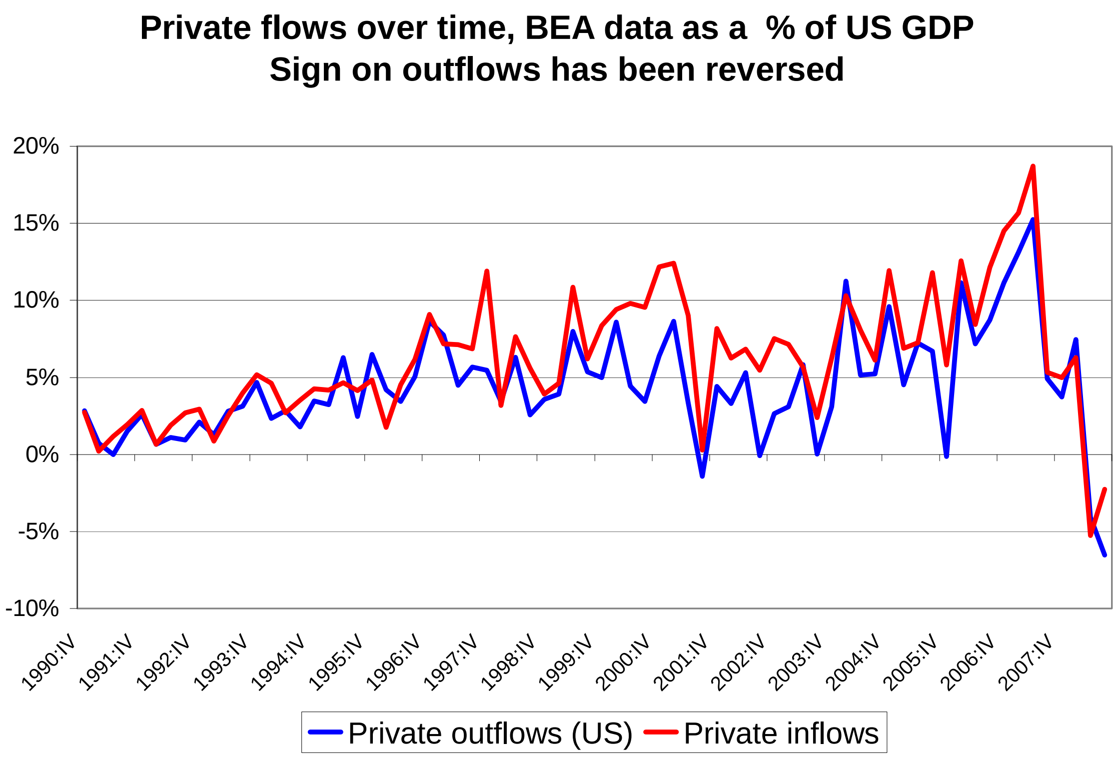

Figure 8: Global reserve growth and estimated dollar reserve growth: IMF data and Setser estimates

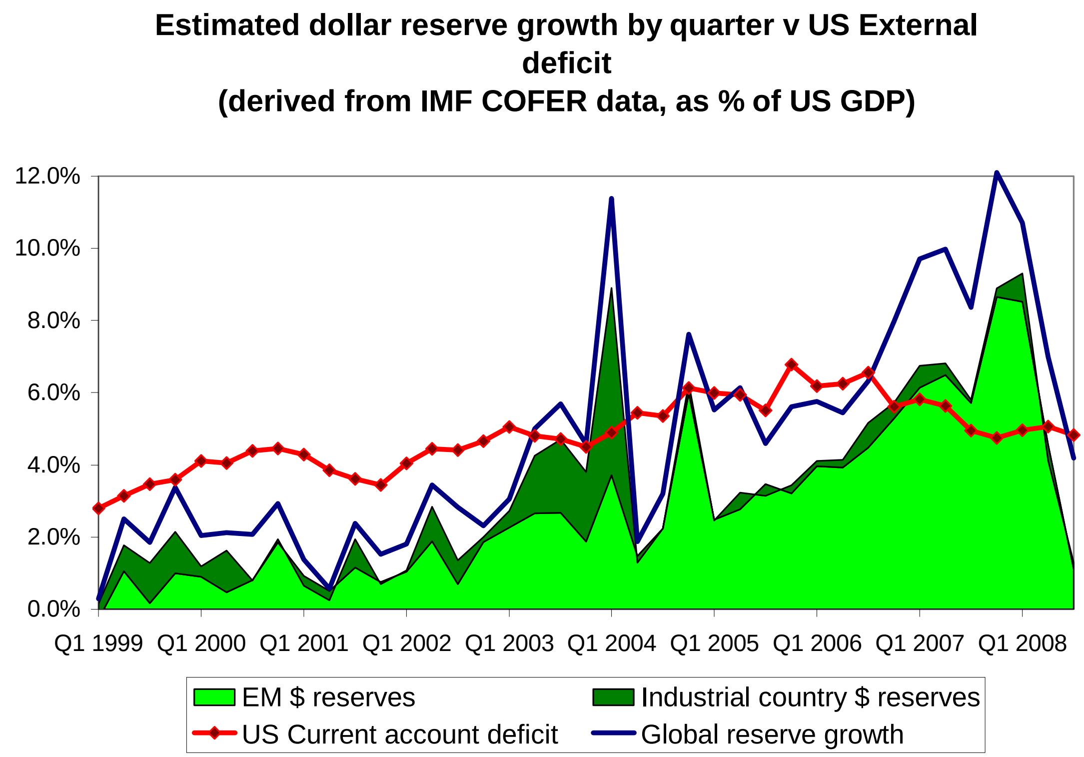

Figure 9: Estimated official purchases of Treasuries and Agencies: rolling 12m averages

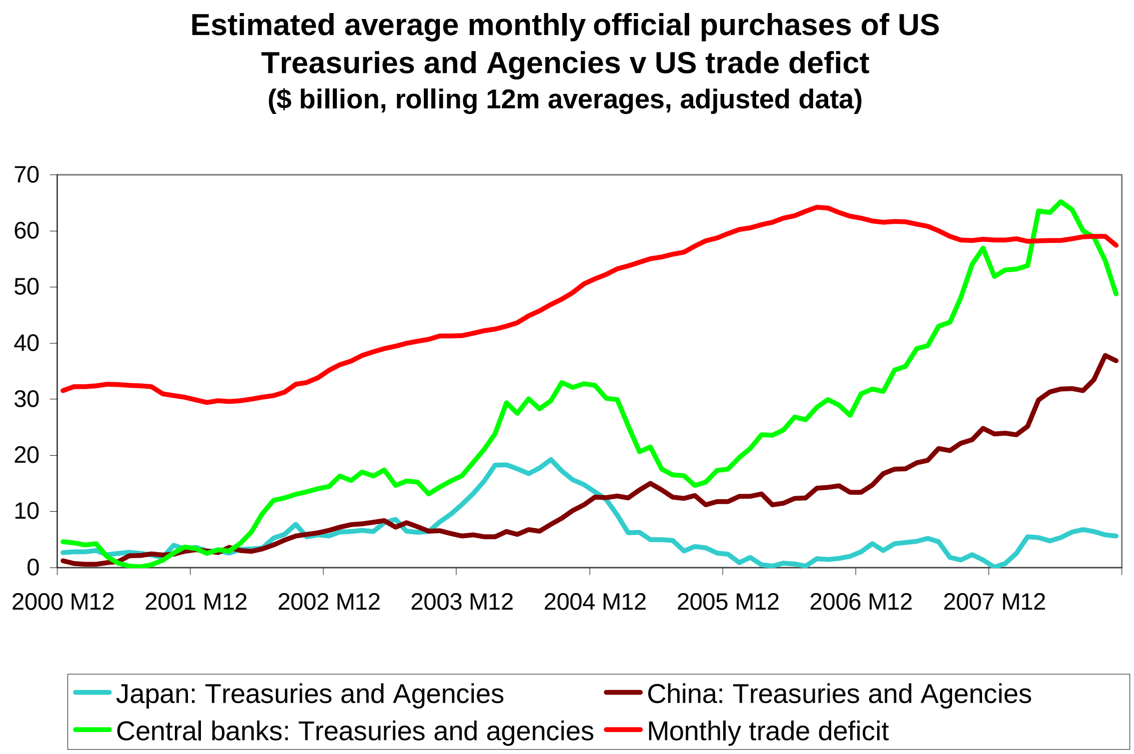

Figure 10: National data points to a further slowdown in reserve growth in q4 2008

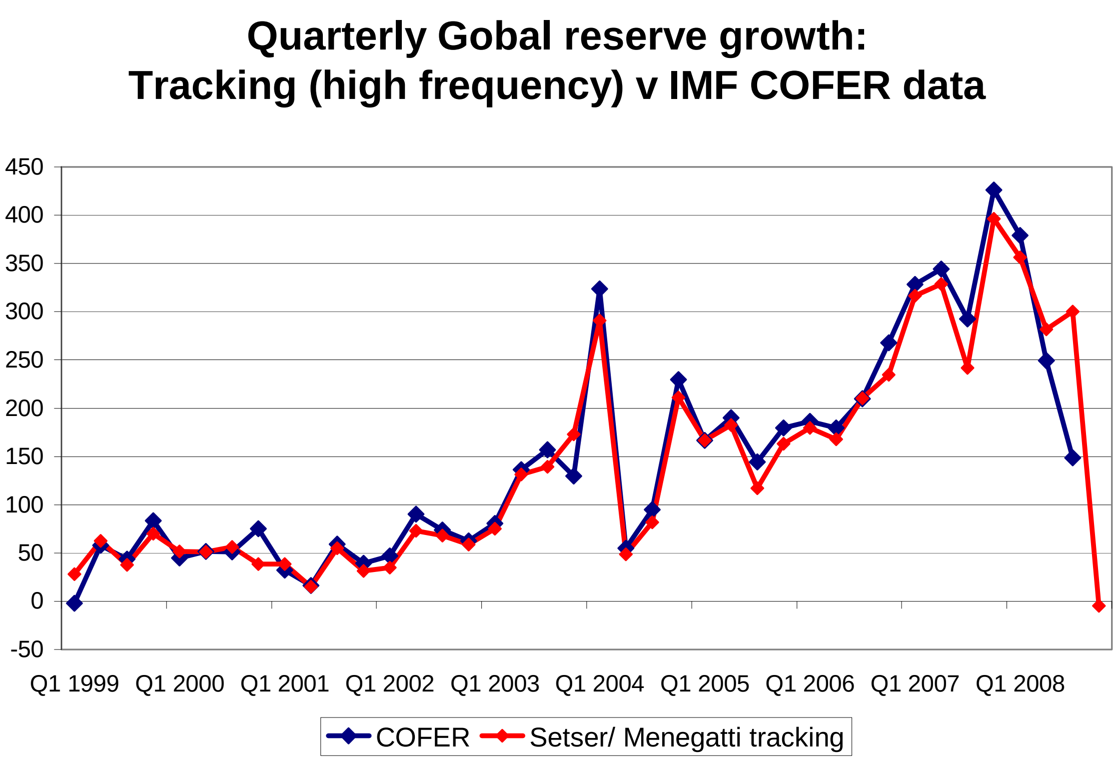

Figure 11: Chinese purchases of U.S. assets: Setser estimates based on the TIC data

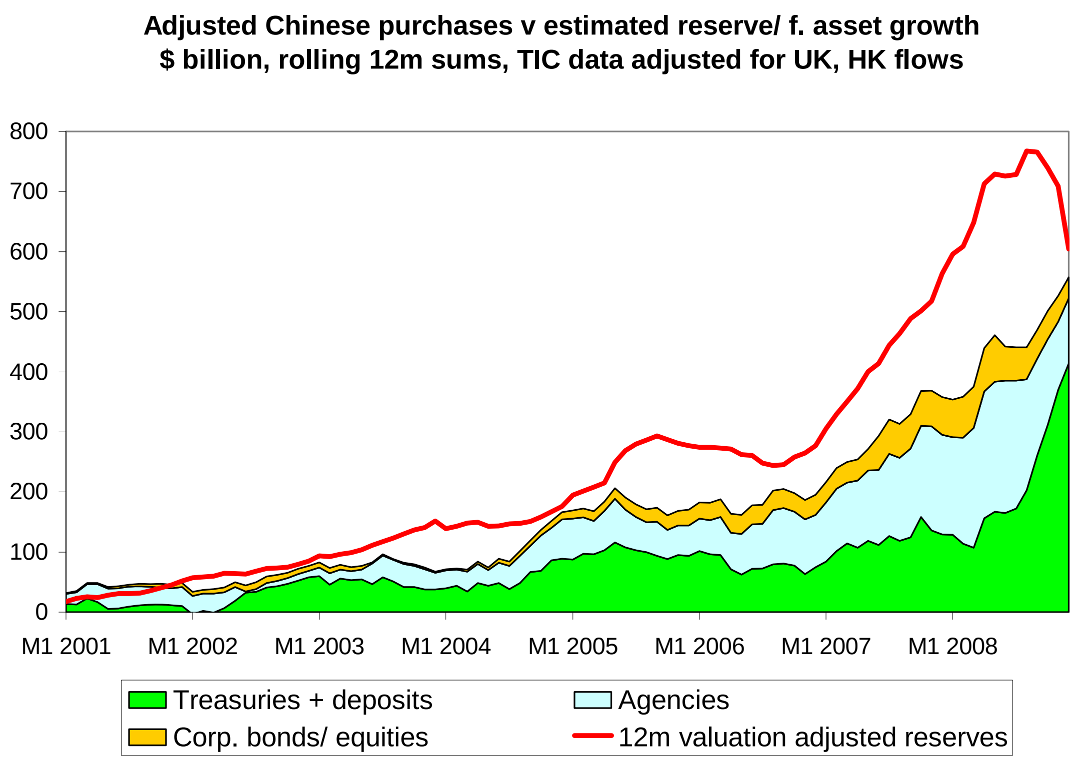

Figure 12: Y/y change (in $ billion) in foreign central banks custodial holdings at the New York Fed

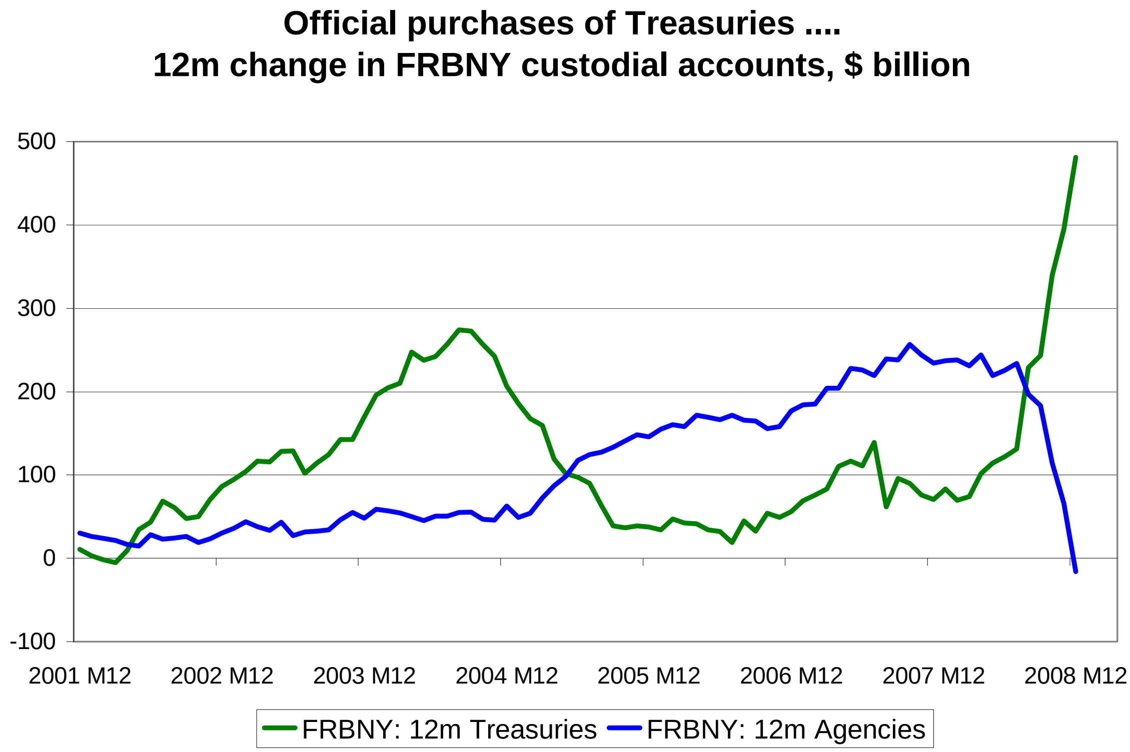

Figure 13: Official demand v U.S. issuance of marketable Treasuries (adjusted to reflect Treasuries released from the balance sheet of the Federal Reserve)