IGE Distinguished Lecture Forum

Speaker	Dr. Martin Feldstein
Topic	"The Global Economy 2014"
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Host(s)	IGE & KITA

Dr. Feldstein presented his analysis of the current state of and prospects for the global economy for 2014, focusing primarily on the United States, Europe, Japan, and China. Here is a brief summary of Dr. Feldstein's lecture.

1. The United States

The US economy is going through changes in a shifting policy environment. These changes are both cause for optimism and concern when looking at the economic prospects for 2014. There are two main reasons for optimism. First, household wealth increases are contributing to GDP growth. Resulting from increased value of the stock market and home prices, household wealth increases have boosted consumer spending. Between 2012 and 2013, household wealth increased by roughly US $10 trillion. This added about US $400 billion per year to consumer spending. This boost has made a permanent contribution and added more than 1% to GDP. Second, the US economy is not currently facing any headwinds resultant from tax hikes or cuts in government spending. Headwinds will be out of the picture for a while because the US Congressional budget for 2014 and 2015 has been set without any additional tax hikes or spending cuts.

Yet, the US Congressional budget's relative shortsightedness and three interrelated economic risks are what make up the concerns. The budget agreement reached by the US Congress is good for the short run but, unfortunately, it does not address the issue of debt and deficit. Before the recession hit in 2007, US debt was at roughly 40% of GDP. By 2012, that number doubled to 75%. Deficit is roughly 3% of GDP. This ratio, without significant measures taken, will continue and rise to 4% in 10 years. There is, therefore, a need to reach a budget agreement that reduces deficit and pushes down the debt to GDP ratio. However, at this point, there has not been progress or compromise between Democrats and Republicans on this matter.

The three interrelated economic risks that are cause of concern are housing prices, net exports, and consumer spending. Housing prices have climbed back after the downturn in 2007. Yet, recently, there has been another downturn due to the increase of mortgage interest rates subsequent to the Federal Reserve's announcement that it would decrease its purchases of long-term bonds. It is now more expensive for people to buy due to increase in house prices, therefore eliminating many potential buyers from qualifying. So in the final quarter of last year investment in residential construction fell at a 13% annual rate, subtracting a few-tenth of a percent point from GDP growth. As for net exports, although there is not going to be any serious decrease, we will not be seeing any strong growth, either. Slow growth of trading partners and the rising value of the US dollar compared to devalued foreign currencies like the Japanese yen are resulting in slow trade. Lastly, consumer spending is in a vulnerable state. Although there has been an increase of household wealth resulting in increased consumer spending, the household wealth is relatively concentrated in the pockets of those with lots of equity. Equity prices have risen in the past year. Investors, therefore, have some pressure on their portfolio, which have caused them to seek higher returns on equities.

The US economy's direction in the future is subject to recent changes and developments in the policy environment. The central concern here is that short-term policies have created a risk of inflation in the long term and there is a need for designing and announcing a strategy to deal with this risk.

President Obama's monetary policies added more to the national debt to GDP. Consequently, the administration has consistently kept its hands off monetary policy since and the Fed came to view itself as the only way of influencing demand. Bernanke's unconventional monetary policies have two components – quantitative easing and forward guidance. Buying large portions of government bonds and relying on forward guidance of short-term interest rates were an attempt to reduce long-term interest rates and encourage portfolio investors to shift to real-estate markets in order to push up household wealth and, thereby, stimulate consumer spending. A tapering of large-scale asset purchasing has begun and it is estimated to be down to 0 by the end of 2014. This will help.

However, there are still three primary risks: an increase of asset prices, an increase of risk taking on behalf of lenders rather than investors, and an increase in risky investing by portfolio investors. Adverse effects *may* not occur because of economic expansion. Yet, should economic expansion slow and the economy get weaker, these three risks will become of serious concern.

In terms of inflation risk, the Fed has not addressed this at all. The Fed has a mandate to maintain price stability and low unemployment. Price stability means controlling inflation. While the Fed has placed a concentrated emphasis on the labor market and the unemployment rates recently, it has not mentioned any plan to deal with future inflation once the unemployment rate settles near 6.5% or 6% or even below. The Fed needs to make it clear to the public how much inflation it can tolerate and how it will deal with it. The Fed needs to announce a strategy in order to create a positive, confident economic environment.

2. Europe

Europe currently is facing little economic risk. However, it is also suffering from poor economic activity. ECB President Draghi has succeeded in reducing interest rates on government bonds. Yet, GDP growth is at about 1% and unemployment is at 12%. Only Germany has a real GDP of more than 1% and unemployment under 10%. All other eurozone countries are outside of that range. There is, therefore, no significant growth to be expected. In addition, European banks are not engaging in enough cross-border lending, which has resulted in a *de facto* lack of a common credit market within the eurozone. The eurozone could fix this problem by devaluing the euro by about 20%. This would allow inflation to rise back to the 2% target and stimulate trade related GDP growth.

The UK, however, has been quite an interesting case in contrast with the rest of Europe. It has combined fiscal authority with currency devaluation and thereby simultaneously reduced budget deficits and stimulated economic growth successfully. Despite decline in the deficit, the UK GDP has increased by 2.8% this year, faster than any eurozone country. Unemployment is also half that of the eurozone with inflation at roughly 2%.

3. Japan

The question for Japan is one of short-term versus long-term success. Abenomics appears to be successful in the short-run, however, structural reforms are yet to be seen. GDP growth is at a 1.5% rate but it is unclear whether or not this is sustainable. The most worrying about the Japanese economy, however, is debt. Japan has a budget deficit of 8% of GDP. If the debt to GDP ratio will continue to rise to about 240%, soon Japan will be forced to finance its debt on international capital markets. This will push interest rates above the 1% for Japanese government bonds. Japan will have little choice but to solve this problem other than by increasing sales tax, which will lead to an economic downturn by taking a cut out of consumer spending. Then, Japan will be on an unsustainable path.

4. China

China is going through a transformation toward more reliance on domestic demand and consumer spending and retail activities, which is happening. It had three decades of double-digit growth but 7% is not bad. If it comes down to 7%, it transforms the economy more going into consumption and services in the process. That way China can create the jobs, rather than very strong but concentrated industrial growth.

The transformation inevitably cannot be perfectly smooth. Therefore, a small negative trade balance is not surprising and it is actually consistent with the Chinese government's goal. Accordingly, a reduced rate of GDP growth is nothing of a surprise.

This, however, will reduce the Chinese demand for dollar bonds, which is a concern. With current account deficit, China is not going to be a buyer. If China wants to go on investing on oil, real estate and businesses, it is going to be a seller and this will contribute to an upward pressure on US long-term interest rates.

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