

InterTradeIreland
Economic Forum 2010

Shaping Recovery

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Outlook for the US and Europe

Barry Eichengreen

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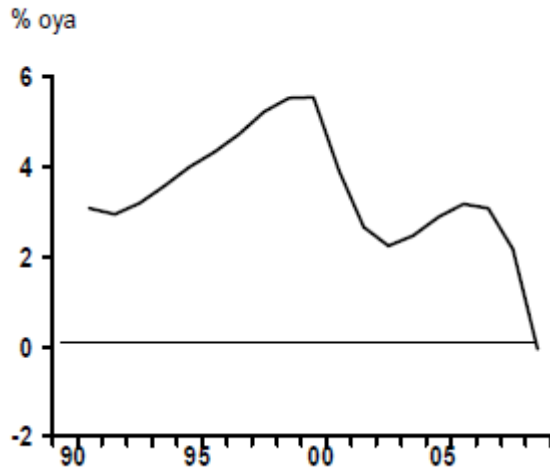
Once upon a time there was
“Zarnowitz’s Law”



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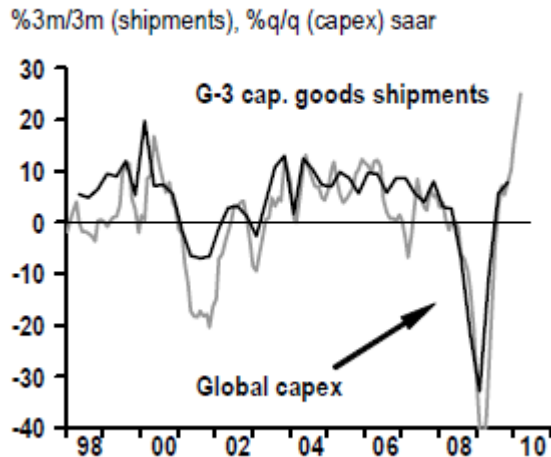
- “ The deeper the recession, the stronger the recovery.
 - . This makes sense at intuitively: the deeper the recession, the more slack there is in the economy, and the more room there is to bounce back.

G-7 capital stock



“ People look at series like these and say “It *must* now bounce back.”

Shipments and global capex



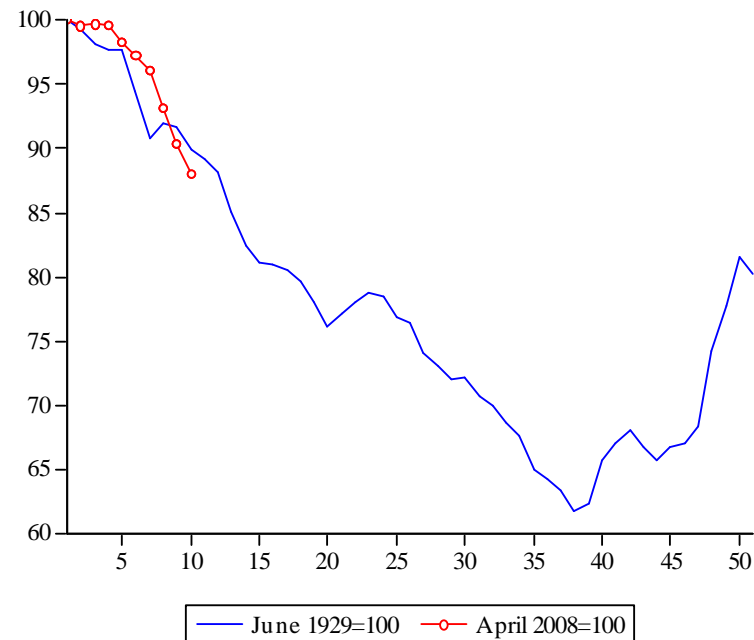
“ JP Morgan wrote this in its “Global Economy Report” last Friday....

- “ So there are still those (for example, Michael Mussa of the Peterson Institute) who believe in the applicability of Zarnowitz’s Law, and believe that the US will grow this year by 4%.
- “ I’m not one of them.
- “ Monetary and fiscal policies succeeded in heading off what could have been Great Depression 2.0.
 - . But in doing so they have bequeathed a monetary and fiscal legacy that will slow the recovery and damage the medium-term growth capacity of the economy. The legacies include:
 - “ Heavy debt burdens and the need now for fiscal consolidation
 - “ Weak household consumption growth as households rebuild their retirement savings
 - “ Continued weakness of housing markets
 - “ Uncertainties surrounding financial reform
 - . Such uncertainties are a problem when the preceding implies the need to redeploy labor from finance and construction to more productive uses.
 - . These are adjustments that cannot be completed overnight, implying a period of slow growth.
 - . And all this is even more true of Europe than the United States

- “ I am not questioning that we should have done what we did, notwithstanding the hangover the next morning.
- “ No question, the policy response was necessary.

Can you twitter?

(*Global* industrial production then and now, with June 1929 and April 2008 taken as the respective *global* business cycle peaks)



How much difference a few months make...

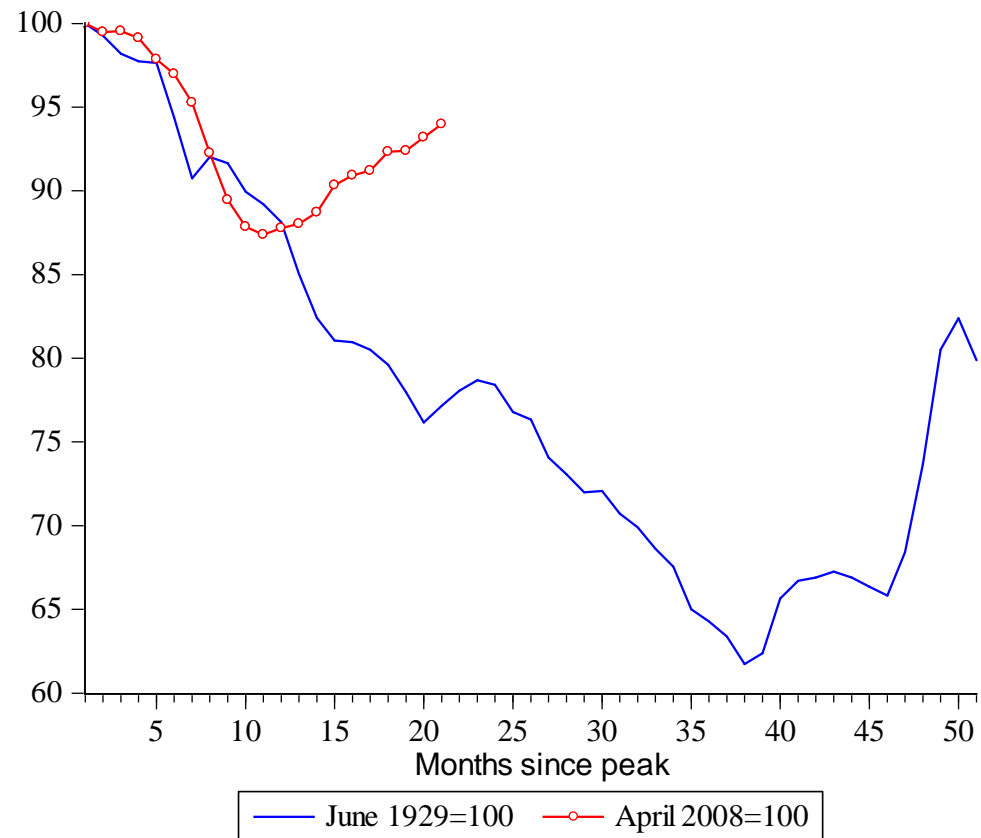


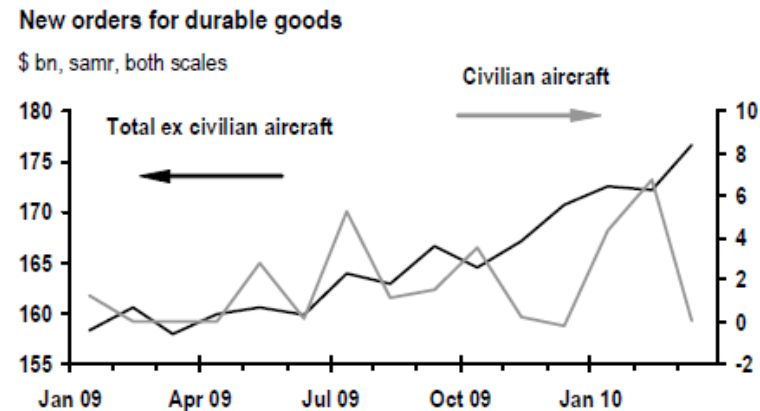
Chart 1
Corporate Bond Spreads Returning to Normal



SOURCES: Federal Reserve Board; Merrill Lynch; Moody's.

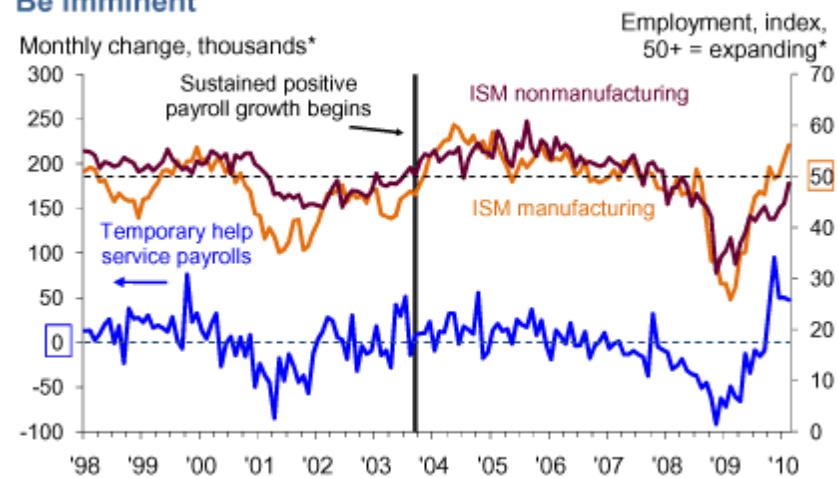
So what are the prospects in the US?

- “ In 2010 Q1, the US economy grew at a 4 to 4.5% annual pace.
 - . Last Friday’s data for March durable goods orders was good. Capital goods ex defense and aircraft rose 4%.
 - . March new home sales up 27% in March over February.
- “ Looks like Zarnowitz’s law at work.



Employment growth in manufacturing is back

Chart 3
Employment Measures Suggest Job Growth May Be Imminent



*Seasonally adjusted.
SOURCES: Bureau of Labor Statistics; Institute for Supply Management (ISM).

“ Again, begins to look like Zarnowitz’s rule.

But there are also problems

- . Uncertain outlook for consumer spending
- . Bank lending is stagnant, as banks have raised their credit standards. (At least bank lending is no longer falling...)
 - ” There is the additional effect of uncertainty around financial reform. I can talk about financial reform in the United States if you like...
- . Withdrawal of stimulus starts now.
- . The prospect that our housing problems are not over.

So what are the prospects in the US?

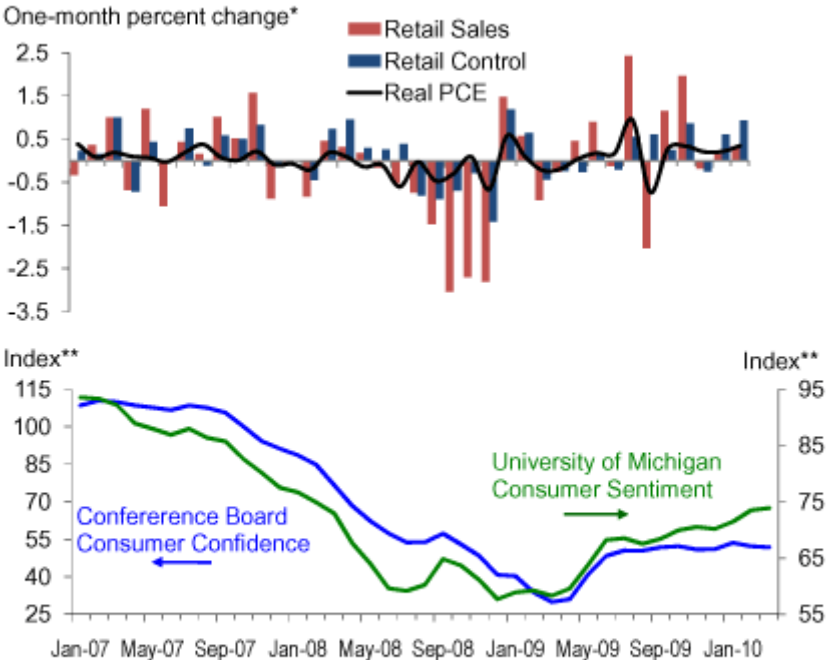
- “ I would argue that they hinge on two things:
- . Consumer spending
 - . Housing market developments

So what are the prospects in the US?

- “ While U.S. growth was healthy in 2010 Q1, as I’ve mention, this was disproportionately inventory rebuilding.
- “ To justify those inventories, we now need consumer spending.

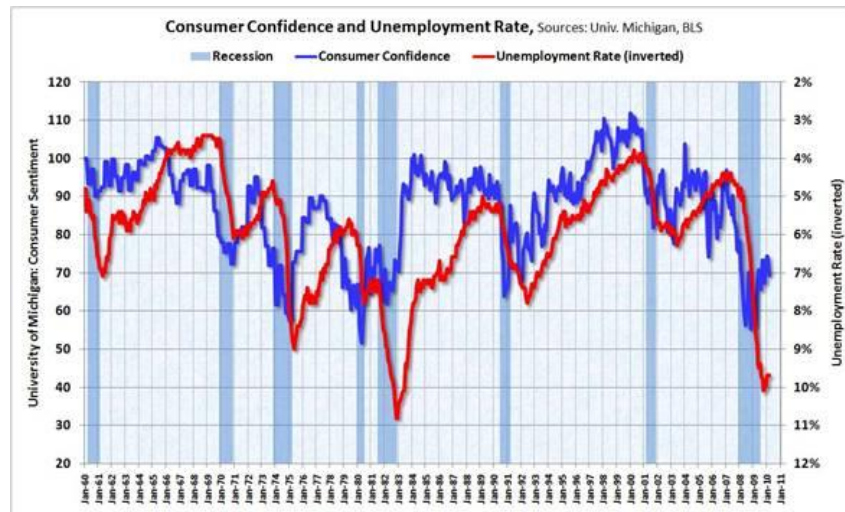
Retail sales have actually been a bit stronger than expected (up 1.6% in March, surpassing expectations)

Chart 4
Cautious Consumers Increase Spending Modestly



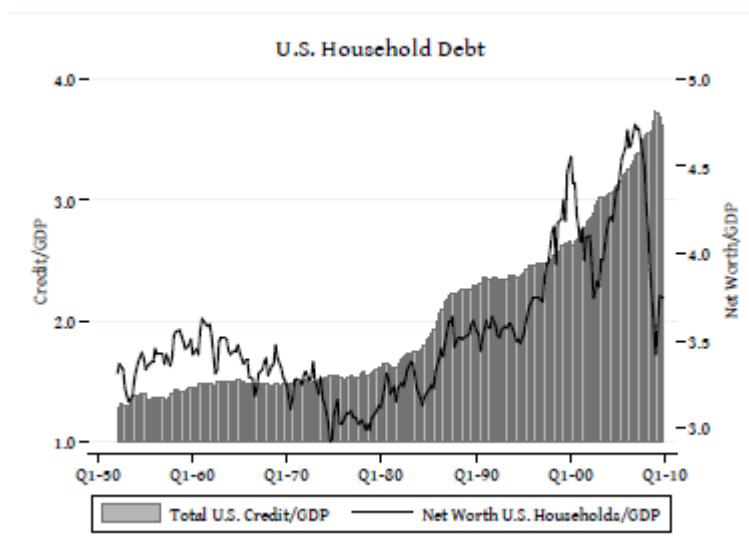
*Seasonally adjusted.
 **Three-month moving average.
 SOURCES: Census Bureau; Bureau of Labor Statistics; Conference Board; University of Michigan; author's calculations.

But the most recent reading on consumer sentiment is surprisingly weak

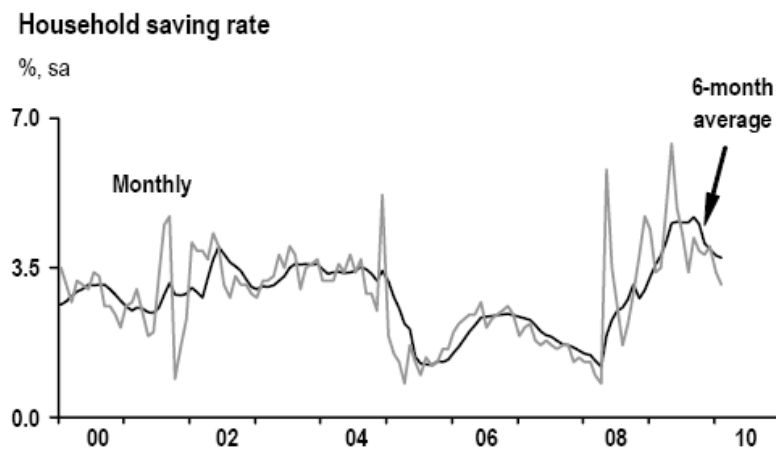


- “ April University of Michigan/Reuters consumer sentiment index was down, at 69.5, from March’s 73.6.
- “ Consumer sentiment goes down while consumer spending goes up?
- “ The best explanation for the consumer sentiment traditionally is unemployment. (Here we see the inverse of unemployment – the red line).
- “ But unemployment has not worsened; it remains stable. So why has consumer sentiment deteriorated recently?
- “ Whatever the answer, sentiment is a leading indicator of spending. It is not reassuring...

Of course, one would expect consumers to remain cautious



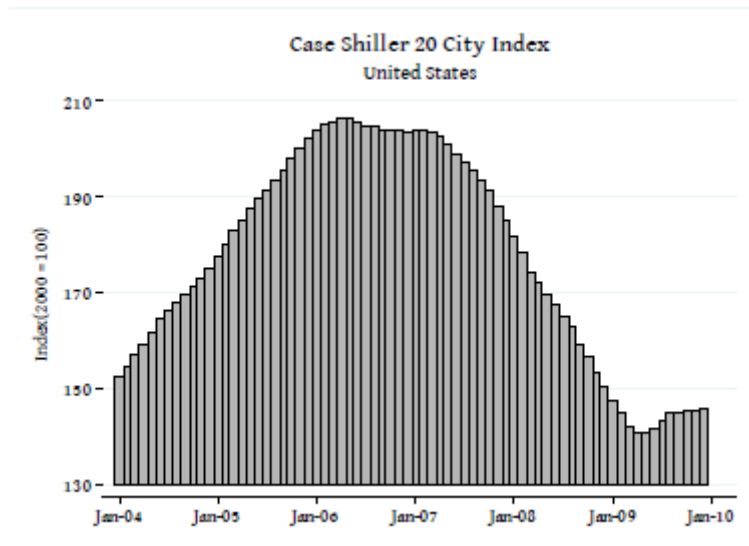
“ Here’s a reminder of what happened to household net worth.



“ One would expect, under these circumstances, to see households keep saving.

- “ The other factor on which outcomes will turn, in my view, is the housing market.
- . Also critically important for consumer sentiment.
 - . Matters also for the health of the financial system.

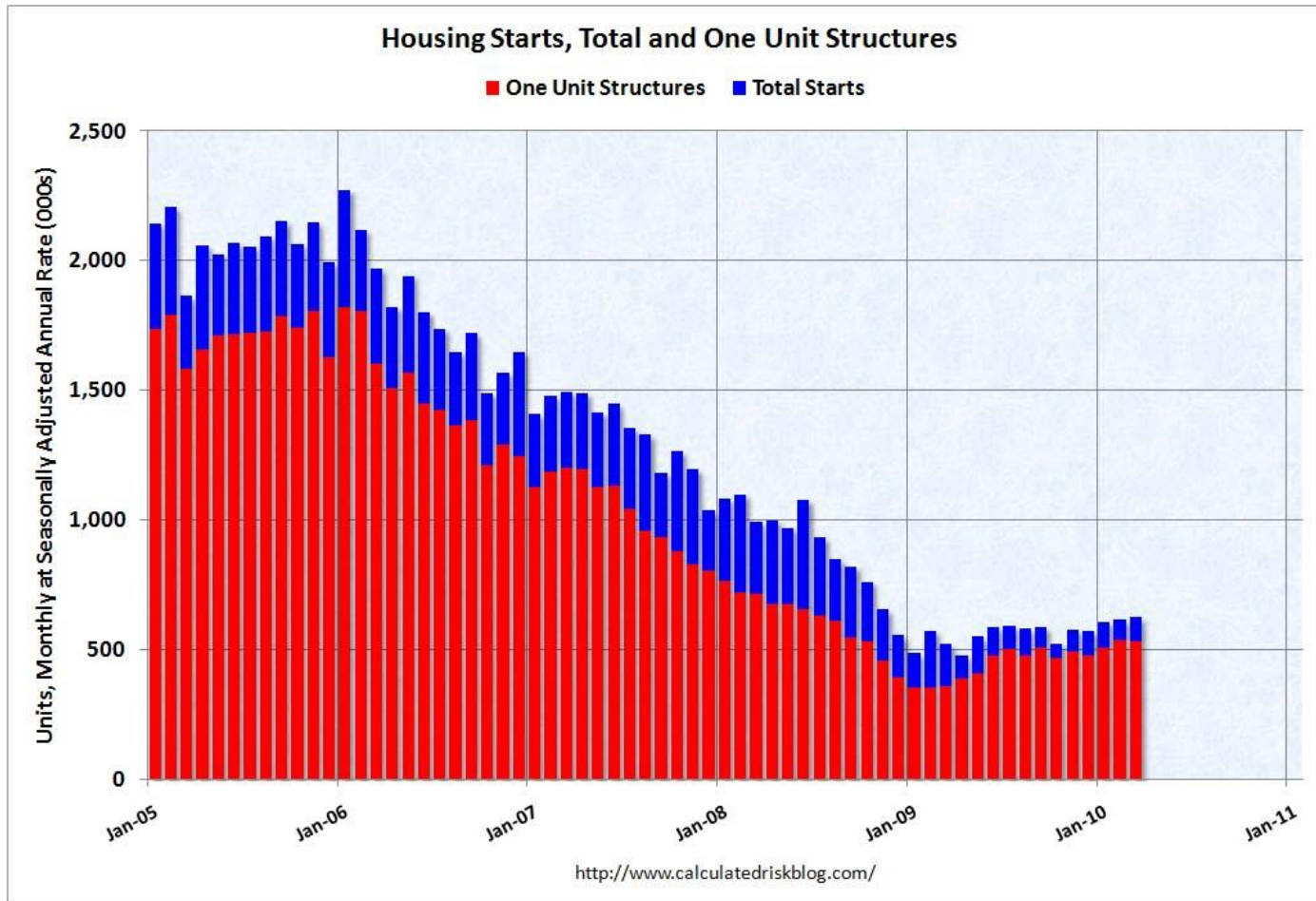
Prices have stabilized for the moment



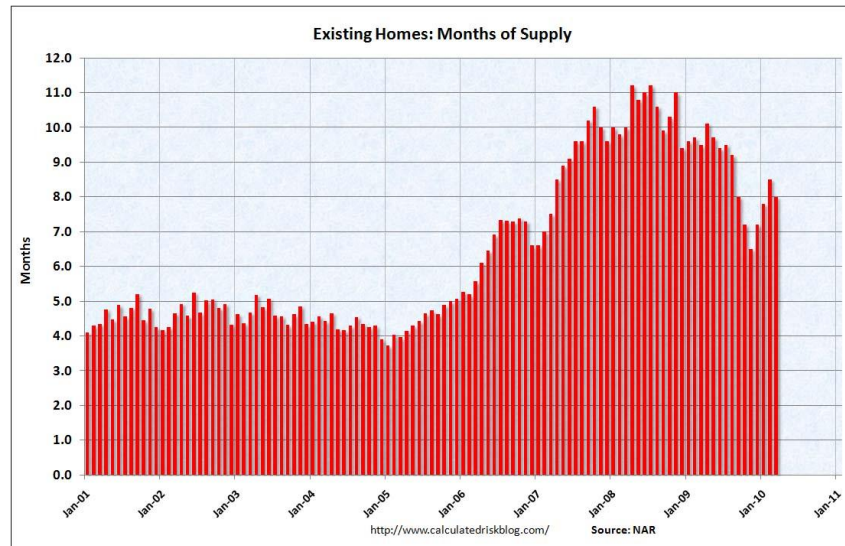
“ Yesterday’s Case-Shiller numbers for February were described as “mixed” – right in line with what you see here (up very slightly February on February).

- They fell 2.2% Jan to Feb 2009, but only 0.8% Jan to Feb 2010, so we get an increase!

Housing starts were up slightly in March



These numbers on months of supply of existing homes came out last Thursday



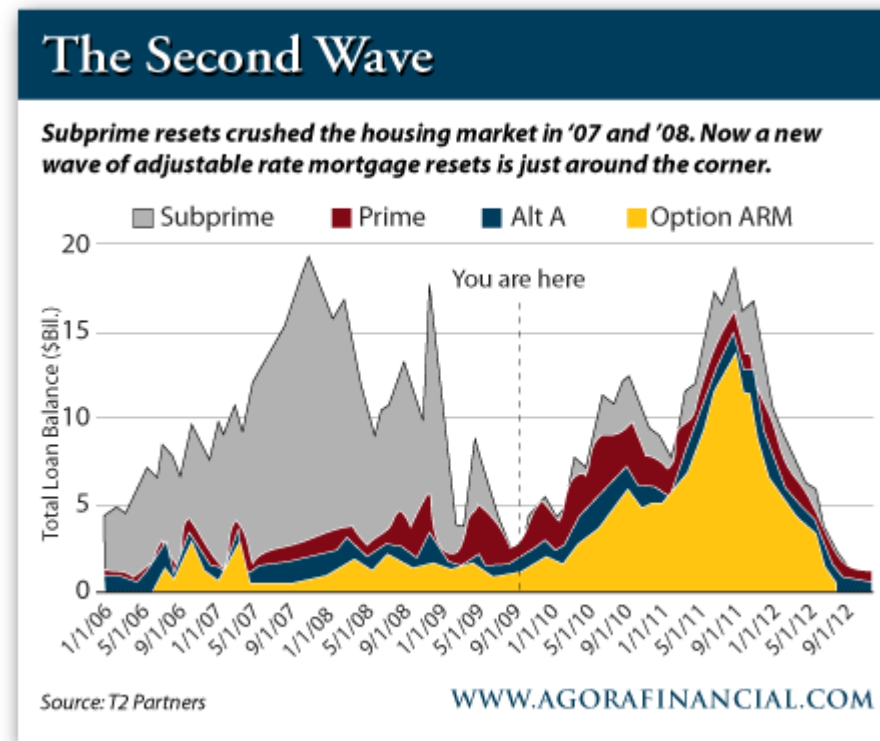
- “ Months of supply is down, which is nice.
- “ But it’s still at 8 months, where 6 months is typical.
- “ And there is shadow inventory out there as well.
- “ Many estimate that the shadow inventory (homes in foreclosure and not on the market, or homes that will be foreclosed on) is very large relative to recorded inventory.

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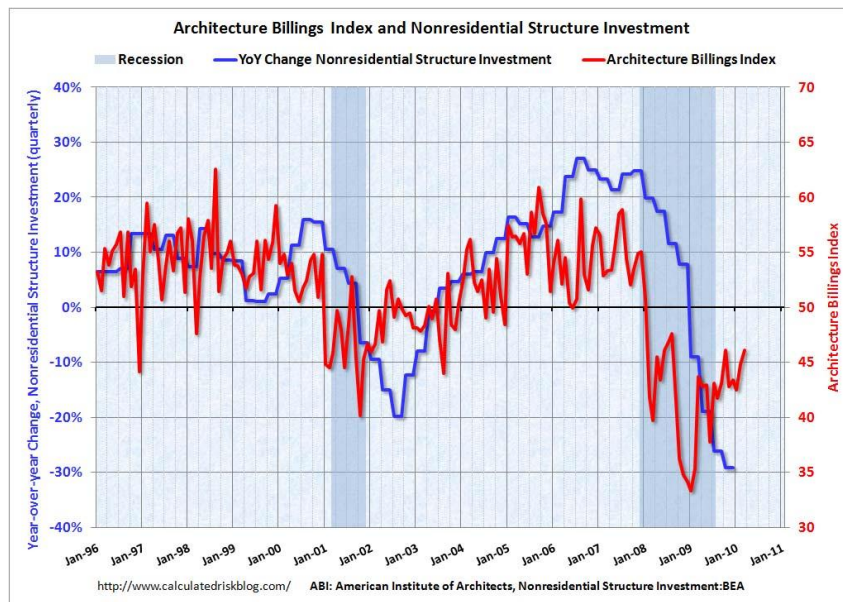


- “ Even if new home sales are up, they are up from what was an historic low.
- “ In any case, it is mainly repossessions and foreclosed homes that people are buying.
- “ Again, there is a big backlog of these out there.

And another wave of delinquencies and foreclosures is coming



There's also commercial real estate



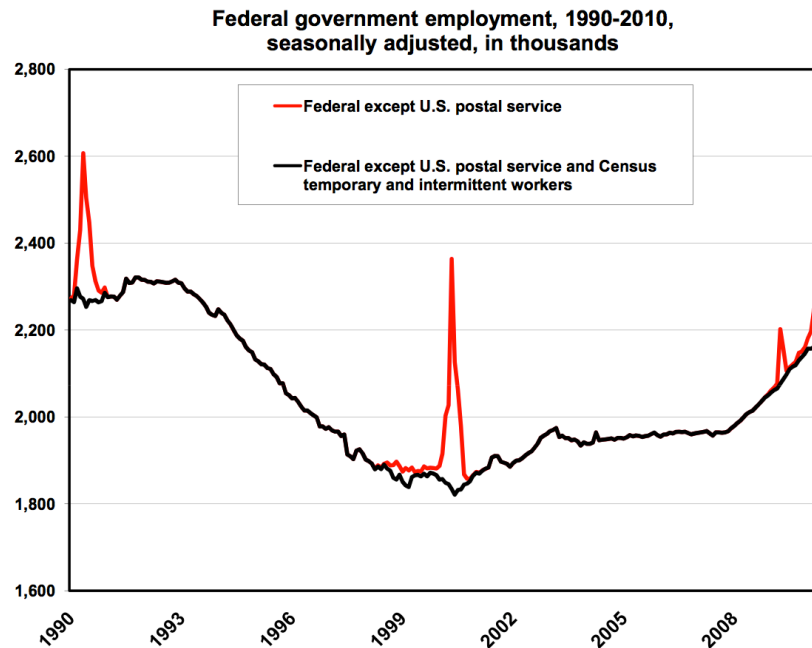
- “ Here’s your leading indicator for commercial real estate as of last Wednesday.
- “ Any reading below 50 means contraction.
- “ So blueprints (plans for building 3 months from now) are still contracting, albeit more slowly.
- “ (The blue line is the year-on-year change in commercial real estate investment.)

- “ So if employment and growth prospects depend on consumer spending and the housing market...
- “ Then what do consumer spending and the housing market ultimately depend on?

What happens next – to consumer spending, the housing market – will depend on employment growth

- “ This logic is circular, I know.
- “ I suggested before that what happens to the economy (employment growth) will hinge on consumer spending and the housing market.
- “ Now I’m arguing that what happens to consumer spending and the housing market will depend on employment growth.
- “ Welcome to the wonderful world of macroeconomics (the world of multiple equilibria).
- “ Employment growth will hinge on expectations. What are employers expecting?

+162K nonfarm payroll employment in March is best since March 2007



” But this also reflected snap back from a snowy February.

” And there was lots of government hiring of temporary census workers.

” And 9 million individuals work part time not for reasons of their own preference.

- “ Latest data from day before yesterday came from the National Association for Business Economics.
- “ The NABE surveys firms on their hiring intentions.
- “ It found that the share of firms expecting to increase payrolls in the next six months went up to 37%, up from 29% in the previous survey three months ago.
- “ So there are some grounds for hope.
- “ While we are in for a weak recovery, it doesn't look like we're in for a double dip...

In sum

- “ US outlook is uncertain.
- “ You didn't need to fly me all the way to Belfast to hear that.
- “ The consensus for 2010 is 3.1%.
- “ IMF (last week) said 3.1%.
- “ My instincts tell me this is too optimistic.
- “ But I think we will avoid a double dip.

Europe



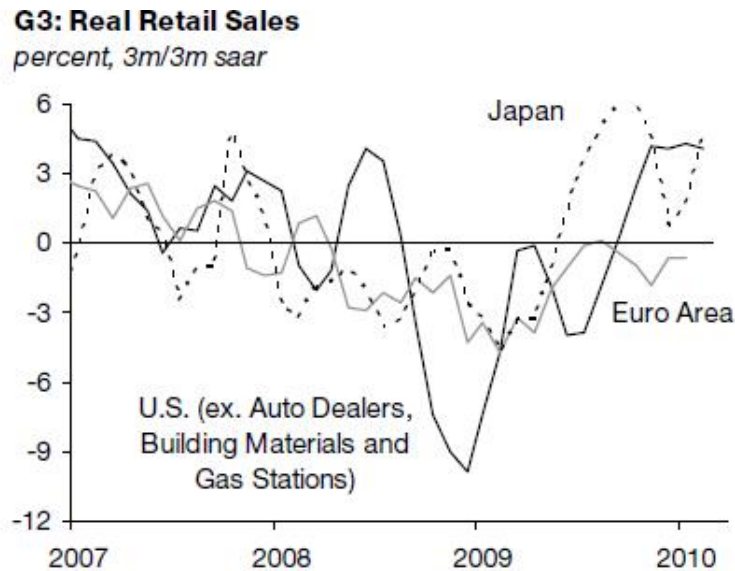
Europe

- “ There are other people here in a better position than I to talk about the prospects for the European economy.
- “ But let me say a few words.

Europe is likely to underperform the US

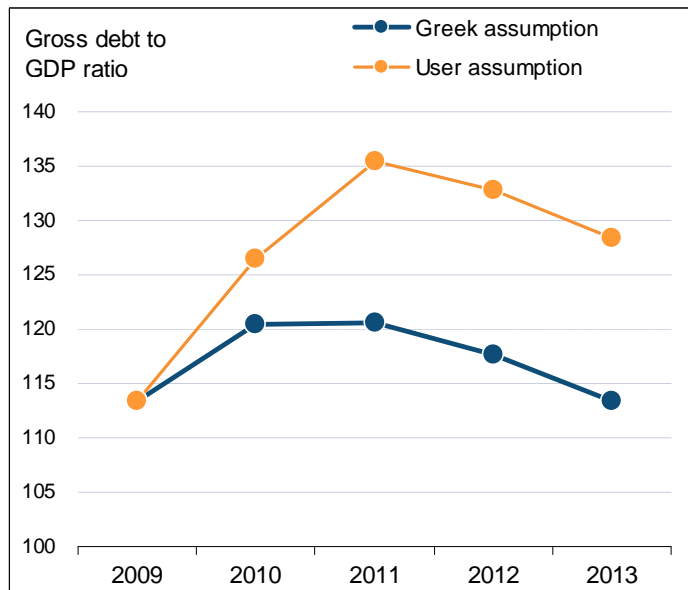
- “ Consensus March 2010 forecast for the euro area is 1.1% growth for 2010 (compared to 3.1% for the US).
- “ There are a number of reasons for this:
 - . Europe did less restructuring to boost labor productivity in the crisis.
 - . Continuing real-estate and bank-related problems in Ireland and Spain.
 - . Less progress than in the US in recapitalizing banking systems.
 - . Monetary policy stimulus was first applied as much as 12 months later.
 - . Slower labor force growth makes for slower aggregate growth.
 - . And, of course, “Greece”.
 - “ Again, I would tend to be below the consensus, although I am again hopeful that Europe will avoid a double dip.

The upshot is that demand growth in Europe is weak



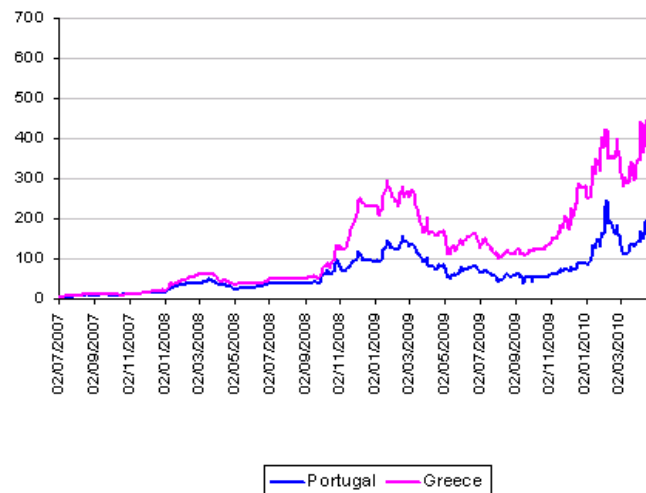
- “ Eurozone industry has responded to global conditions like other industry.
- “ Regional business surveys do not look especially bad.
- “ But eurozone domestic demand indicators are relatively weak (see left).
- “ Same problem as in the US, in other words, but even more pronounced.

A few words on Greece



- “ They have now formally requested IMF/EU funding, which will take them through the end of the year.
- “ But they are going to have to restructure unless they miraculously cut costs and get growth going again.
- “ Here I have juxtaposed the official Greece forecast for the debt with what happens when the IMF and EU fully fund the debt in both 2010 and 2011 but nominal growth is -5% both years.
- “ You can see that the debt/GDP ratio approaches 135%. 7% of national income, or a quarter of the budget, goes to debt service. Neither the markets nor the Greeks will stomach this.

The other three sovereigns are not out of the woods, but they're in better shape



- “ They have enough liquidity to make it through the year without official help.
 - . The Irish government entered the year with EUR20bn in cash, enough to cover its gross financing requirement for the year.
- “ They have more credibility.
 - . None of the others have grossly misreported their budget numbers twice since EMU entry.
- “ Solvency problems are less.
 - . Irish public debt end 2009 was “only” 54% of GDP, Portuguese 66%, Spanish 77 per cent.
- “ But Portugal shares Greece’s problem of a very low savings rate.
 - . Very high level of external indebtedness, due mainly to the private sector.
 - . That is why the markets are focusing now on it as well.

We are in for a tough two weeks

- “ The Merkel Government will want to delay agreement on terms until after next week’s regional elections.
- “ 85% of Germans polled oppose a bailout for Greece.
- “ It will then have only 10 days before E8.5 b. of Greek bonds mature to cobble together a domestic political compromise.
- “ This is a high-stakes game, especially if that delay causes Portuguese spreads to blow out.
- “ In the end, I think there will be a package for Greece (more like E80 b. over two years) and, maybe late this or early next year, a smaller one for Portugal.
- “ This will give the countries concerned some time to get their acts together.

So what happens if Greece doesn't get its act together

- “ At some point (presumably after the first year), Greece's EU partners and the IMF pull the plug.
- “ Greece will be forced into default.
- “ To put it on a path to fiscal solvency without help, it will have to write down the debt by perhaps 50%.
 - . The markets are currently pricing in 35%; Argentina did 75%.
- “ This would bring the country's debt/GDP ratio to 60%, allowing it to run a deficit of 2.5% of GDP while keeping the debt ratio stable (assuming nominal growth of 4%).
 - . A 50% haircut would pose problems for German and French banks, but the German and French governments could deal with these if necessary.
 - . There are also a number of clever schemes out there to stretch out the debt without requiring the banks to declare losses (although the stretch-out will still punch a hole in their balance sheets).
- “ Of course Greece would only be compounding its problems if it attempted, at the same time, to withdraw from EMU.
- “ Question: given how the Greek crisis is causing the euro to weaken, is this a hidden boon for Europe?

And the UK

- “ March 2010 Consensus puts 2010 growth at 1.4%.
 - . First quarter, at 0.2%, was very weak, as you know.
 - . Reflects weak demand (weak spending on hotels, eating out etc.).
 - “ Could have just been the weather, but one wonders...
- “ Again, you will know the good reasons why UK growth will lag that in the US:
 - . Dependence on finance and real estate.
 - . Serious fiscal problems and need for sharp consolidation.
 - . Hung parliament?
 - “ On the other hand, maybe having a flexible exchange rate will be an advantage under these circumstances. (We are about to find out...)

- “ Clearly, there will be lots for us to discuss.
- “ Thank you very much.