A SYMPOSIUM OF VIEWS

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com

Is the World Becoming *Immune* from America?

Two dozen experts share their thoughts on a question with serious implications for the future of globalization.

Recently, The Economist *magazine editorialized that any further U.S. economic slowdown in 2007 is unlikely to impede the growth of the rest of the world. In a world where America has been the consumer of last resort, "buoyant Asian demand should help keep Europe afloat despite a U.S. slowdown," the editorialists opined. European Central Bank President Jean Claude Trichet recently offered a similar assessment: "A 1.0 percent slowing in the United States" would subtract only "0.2 percent from growth in the Euro area, taking into account the echo effect from the rest of the world."*

The counter argument is that because the Asian economies and the larger economies of the eurozone have become so export-dependent (while facing serious demographic problems in the years ahead), it is unlikely that a strong burst of consumption will rise up to take the American consumer's place. Some analysts add that the argument really centers on the effect on the world economy if U.S. growth drops below 2.0 percent. In other words, for every 1.0 percent U.S. growth declines below the 2.0 percent threshold, the Euro zone and Japan will decline 1.5 percent, with China and the other Asian economies declining perhaps a full 2.0 percent.

Historically, U.S. slowdowns and recessions have led to global slowdowns and recessions. Is that still true today?

Those who believe the world is becoming immune are kidding themselves.

KENNETH ROGOFF
Professor of Economics, Harvard University, and former Chief Economist, International Monetary Fund

The share of the United States in global output has indeed fallen over the past decades; it is now 20 percent, down from 25 percent. However, the reduced importance of the U.S. economy for world growth is partly an illusion, because the volatility of U.S. output growth has also dropped from what it was in the 1970s and 1980s. The fact that the United States has not been causing global business cycles as much as it used to does not imply that it no longer has the economic heft to do so.

That said, the United States' historical role in causing global business cycles is often exaggerated. The correlation between U.S. and other G7 country business cycles has historically been around 50 percent. However, a large part of this correlation owes to common shocks (oil, technology, housing), rather than to direct trade and financial linkages. That fact that U.S. income shocks seem to be such reliable harbingers of foreign shocks is partly because U.S. data is better and more reliable. It also tends to come in first. So no, Europeans (and Asians) who think that they don't need to worry if the U.S. economy tanks are kidding themselves.

The key point: America's economic influence reflects its dynamism and ideas, not its market share.

JAMES E. GLASSMAN
Managing Director and Senior Economist, JPMorgan Chase

The global economy has been hibernating for almost a decade. Asia's financial crises in the late 1990s left a deep scar across the region. Japan has been struggling with deflation. And Europe's growth has been frustratingly slow. All that seems to be changing and the global economy now is growing at its fastest pace in a long time. Does that now mean that America's economic influence will be on a slow decline?

It is true that the U.S. economy, with 5 percent of the world's population, has accounted for almost one-fifth of global economic growth since the late 1990s until recently. Global economic prospects are brightening as the industrial economies accelerate. Developing countries are emerging from the economic Dark Ages. If these promising trends continue, the U.S. economy will account for a smaller share of global economic activity.

But America's economic influence reflects its dynamism and ideas, not its market share. Indeed, U.S. exports will stand a much better chance when others achieve their full economic potential. Economic progress is not a zero-sum game, but instead enables the entire sum to grow, with benefits for everyone.

America's economy remains a global power house and its economic influence is still on the rise. America's current partnership with East Asia and India will do for 50 percent of the world's population what the Bretton Woods system did for 10 percent of the world's population from 1947–73. The linkup to the U.S. economy that helped to revive Europe and Japan after World War II certainly didn't drain energy from the U.S. economy. The resulting U.S. trade deficit was just another footnote. The emergence of a new Asian economy stands to strengthen America's standing in the global economy.

America's dominance in the global economy isn't about its physical infrastructure. Rather, its competitive market economy, intolerance of corporate governance flaws, risk-taking culture, and dynamic capital markets all reward entrepreneurs for transforming ideas into useful goods and services. Its dominance comes from the flexibility of its businesses to reinvent themselves amid sweeping global changes.

Predictions of the waning dominance of the American economy often fall out from a confusion about the forces driving the outsized U.S. international trade balance. Pessimists warn that destabilizing "global imbalances" are occurring because America is living beyond its means. It finances its "addiction" to consumption, the story goes, by borrowing from foreigners, including poor nations. After all, U.S. household saving is negative and the fiscal budget is in deficit. They believe that at some point America will be forced to abandon this reckless course and when that happens, its dominance will fade.

This vision is deeply flawed. In fact, the U.S. trade deficit has nothing to do with the United States. If U.S.

over-consumption were the cause of global imbalances, the U.S. economy would be overheated. This is certainly not the case. For five years the economy has been recovering from a recession, even as the trade deficit widened. Indeed, as the trade deficit was deteriorating, U.S. policies were appropriately focused on economic revival. Benign inflation and labor's extremely low share of income relative to GDP are proof that the United States remains on a sustainable path. If U.S. consumers had not responded to rising net worth by saving less, or if U.S. fiscal policy had been less stimulative, the Federal Reserve would have needed to hold interest rates down for considerably longer than it did in order to revive the U.S. economy.

In fact, the U.S. trade deficit is the result of slow-growing industrial countries and rapid development in emerging economies. It reflects the profoundly favorable and stabilizing developments that are doing more to cure poverty than any other effort in memory. New consumers in most developing economies are too poor to reciprocate by purchasing goods and services made abroad. So, obviously rapid growth of developing nations is not benefiting U.S. exports just yet. This will change, however, as living standards rise across Asia.

From this perspective, the U.S. trade deficit is a positive force, a measure of the dominant role of the U.S. economy and its consumers in the unprecedented pace of globalization under way.

For those who fear the United States no longer makes anything the world wants and is slowly losing its global dominance, the truth is that the United States exports the most valuable commodity known. It exports hope and the promise of an idea that free markets are the most effective way to improve the living standard of the world's population. Asia's embrace of free market economics sends a powerful message that economies that embrace market principles will be tomorrow's economic powerhouses.

America is still relevant.

C. FRED BERGSTEN
Director, Peterson Institute for International Economics

A country or region must fulfill three characteristics to have an important impact on the global economy. It must be large. It must be dynamic, enjoying reasonably rapid growth. It must be relatively open to the rest of the world, with sufficiently deep international integration to produce important external repercussions from its own activity.

Only three components of the world economy now meet these three criteria: the United States, the European Union, and China. Japan, though the second largest national economy, never became sufficiently open to have a major global impact even during its decades of very rapid growth. Korea is neither large enough nor open enough. India is very large and growing very rapidly but is still too closed to outside influences to have much worldwide impact.

Significant changes in economic activity in any of the three current economic superpowers will have important effects on the global economy as a whole. The United States is no longer alone in levying such effects, however, as it was in the early postwar period. Nor is it joined in that impact only by the unified European economy, as it was until the last few years. China has now joined this league and will have an increasingly important international impact as long as its rapid growth, and open trade and investment policies, continue.

If the United States slows seriously, Asia and Europe should brace themselves for a sudden halt to growth.

TADASHI NAKAMAE
President, Nakamae International Economic Research

The world should brace itself for a sudden halt to growth if the United States enters a recession. Contraction in the consumption-driven U.S. economy will trigger a drop in the country's appetite for imports, thereby reducing its huge current account deficit. The narrowing deficit will, in turn, be a drain on global liquidity.

The biggest problem facing the world economy—Asia, in particular—is excess supply capacity. The investment boom of recent years has led to a large over-

supply of many tradable goods (steel, cars, electronics, and so forth)—most dramatically in China. Any decrease in demand will further raise surplus capacity. Worldwide capital expenditure—especially export-related investment—will be the first victim of a U.S. slowdown.

In a vicious cycle, for every fall in capital investment due to slowing exports, overall demand will weaken further as capital expenditure generates a large share of demand. At the same time, capacity will continue to increase in the short term as previously committed capital expenditure is completed. Fresh capacity in already oversupplied markets will only intensify the downward capital expenditure spiral.

An explosion in real estate and related construction activity has been the most significant economic side effect in terms of liquidity. Take the worldwide housing boom. After capital expenditure, real estate has been the key growth engine for the global economy, outside the United States, in recent years.

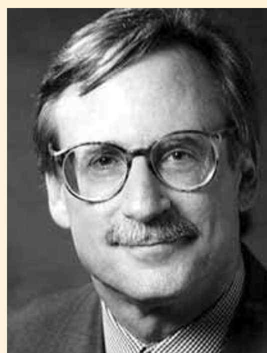
Thanks to highly accommodative monetary policies in the United States and Japan from 1997 to mid-2006, the world economy is flush with liquidity. The Federal Reserve aggressively eased policy after the Asian currency crisis, Russia's default, Long-Term Capital Management's collapse, the bursting of the information technology bubble, and the terrorist attacks in September 2001. Across the ocean, the Bank of Japan lowered interest rates to zero in response to a banking crisis.

The root, however, of the current global liquidity glut was the outsized growth of the U.S. current account deficit. For every dollar added to America's debt, a new dollar was added to the world monetary pool. This spurred a rash of speculative financial activity.

As the U.S. economy weakens and its current account deficit starts to shrink, years of rampant money creation will come to an end. Tighter monetary conditions will lead to a shortage of U.S. dollars for foreign economies. Both the Asian and European real-estate markets will suffer as a result.

The extent to which personal spending can replace capital expenditure and real estate as a driver of economic growth depends on whether income is transferred from companies to households. Even as corporate profits and investments soared as a result of globalization, wage growth in most countries was anaemic. Companies need to reverse this trend by raising wages in order to enhance consumers' buying power. Yet given that falling capital expenditure and real-estate activity will hurt corporate profits, it is unlikely that companies will do this. Instead, they may even start cutting wages.

With households and companies becoming strapped of cash, it is unlikely that Asia and Europe will remain buoyant as the U.S. economy slows down.



The notion that the world is becoming immune is foolish.

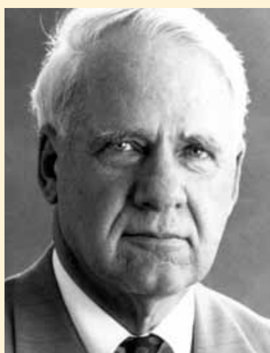
MICHAEL J. BOSKIN
T.M. Friedman Professor of Economics and Hoover Institution Senior Fellow, Stanford University, and Former Chairman, President's Council of Economic Advisers

The notion that the world is becoming (economically) immune from America, or that there is a magic level below which U.S. economic growth must collapse before affecting anywhere else, is foolish. To be sure, short-run cyclical and medium-term growth trends in other parts of the world today are pretty favorable, so a U.S. slowdown might not by itself be sufficient to cause a substantial global slowdown. But make no mistake, the world will be better off when the United States gets back to its non-inflationary trend growth somewhat over 3 percent. While American propensities to spend on imported goods as income grows are larger than other countries' analogous propensities, both for the export demand and the general reduction of tensions over global imbalances, growth abroad is good for us.

It is not sufficient to examine the aggregate data on the U.S. growth slowdown. Because residential construction and domestic autos are leading the way with sharp downturns and there has been thus far only minor correlative damage, the epicenter has not been disproportionately in the traded goods center. It is too early to tell how history will play out this episode.

While a soft landing is the most likely scenario, for the first time in this expansion one must ask whether the long period of very low interest rates, the resulting housing bubble, and consumption boosted by unsustainable housing wealth effects have driven unemployment below the natural rate, creating accelerating inflation pressures which are still to play out. Or whether the inevitable correction in housing values and retrenchment in residential construction, plus the domestic auto woes, will inexorably spread to the rest of the economy. Or both.

The betting here is that we will muddle through and not test the view, at least for very long, that 2 percent or lower U.S. growth will wreak havoc on Europe, Japan, China, and the rest of the world.



Yes, the United States is no longer the indispensable sparkplug.

JAMES SCHLESINGER
Former Secretary, U.S. Defense and Energy Departments, and former Director, Central Intelligence Agency

The U.S. economy, while large, is no longer crucial in the way that it used to be. Its role has been diluted by the continuing Asian boom. While it is no longer true that "when America sneezes, Europe catches cold," an American sneeze may be followed by some sneezes elsewhere. Thus, while one can hardly say that the world has become immune to America, it is now less sensitive to its emanations.

The boom in China rolls on. Sustaining aggregate demands has not been a problem; for China, restraining total demand has been the challenge. Exports have been growing by 25 percent annually—and modest adjustments in that growth rate will not be crippling. Moreover, the United States is no longer the indispensable wellspring of technology. To be sure, while the Asian boom continues in China and elsewhere, Japan is a more problematical case. Still, the conviction that the United States remains the indispensable sparkplug for the international economy is no longer valid. In the 1980s and 1990s, the United States remained the driver. Now, however, we can slow—and the rest of the world need not.

The Europeans should avoid the Duisenberg mistake.

EDWIN M. TRUMAN
Senior Fellow, Peterson Institute for International Economics, and former Assistant Secretary, U.S. Treasury, and Staff Director, Division of International Finance, Federal Reserve Board

Whether global growth suffers an economic slowdown with the U.S. economy in 2007 depends in large part on whether one thinks there will be a significant slowdown in the U.S. economy. In the more likely scenario, if U.S. growth slows into the 1.5 to 2.5 percent range, one will not likely be able to detect much of an effect in the rest of the world; the effects of the mild U.S. slowdown will be washed out by noise. If the U.S. economy goes into recession or close to it, then growth in the rest of the world will be discernably affected.

It is true that the U.S. economy's share of the global economy is shrinking and will continue to shrink. It is also true that with the exception of 2001, the global economy has depended disproportionately for stimulus from the U.S. economy. All of this suggests to me that policymakers in the rest of the world would be unwise to repeat the mistake that Wim Duisenberg made as President of the European Central Bank when he asserted that the euro-area economy would be unaffected by a U.S. slowdown or recession. The implications of the performance of the U.S. economy for the performance of the global economy extend well beyond narrow trade linkages. To the extent that policymakers' outlooks overestimate U.S. growth in 2007, I am confident that they are also overestimating rest-of-the-world growth as well, so surprises in 2007 are likely to be on the downside.

The belief that Europe is insulated is myopic.

JULIAN CALLOW
Chief European Economist, Barclays Capital

Whatever's happening, there are so many economists that you can be sure that at least some will be trying to argue in a non-intuitive way. Most famously we saw this with attempts to justify inflated equity valuations at the peak of the previous stock market cycle. As well, there was a tendency in Europe during the first half of 2001 to downplay the consequences of weak U.S. GDP growth, in the myopic belief that the

euro area economy had somehow become more "closed" and self-supporting following monetary union.

So once again we hear arguments that "this time it really is different," that fortress Europe really has cut loose from the U.S. cycle. Yet intuition suggests that "animal spirits" are just as relevant as they were when Keynes first referred to them to explain economic behavior—and that the abundance of information now available in our globalized economy and financial markets implies that these are likely to be more synchronized than ever before.

Moreover, history tells us that it is very hard for the rest of the world to perform differently from the U.S. business cycle. From a euro-area perspective, econometric models suggest that if U.S. GDP growth slows by 1 percent, then the impact on euro area GDP might be 0.2 percent. But if growth in the global economy slows down by 1 percent, then the impact on euro area GDP would be 0.5 percent—a more serious consideration.

Hence the key question is to what extent the rest of the world can have a different business cycle from the United States. Like it or not, the fact is that GDP growth in the rest of the world tends to follow closely the trend in the United States. An added complication is that when the United States does slow down, the dollar tends to slide. Even if central banks outside the United States were quick enough to try to forestall the consequences of a U.S. slowdown by easing policy aggressively, it is doubtful that lower rates would bring forward stronger demand outside of the United States quickly enough—especially if the dollar were sliding. Besides, it remains very doubtful whether in practice monetary authorities outside of the United States would have the boldness to respond to a substantial U.S. slowdown by easing aggressively.

In the age of globalization, no country can be immune, but they can strengthen their immune systems.

NORBERT WALTER
Chief Economist, Deutsche Bank

In the age of globalization, no country can be immune to a slowdown of the largest economy of the world. The best that countries can do is to have a strong enough immune system so that they only end up with a sore throat rather then needing to be rushed to the emergency room.

For us abroad, the nice thing about the current downturn in the United States is that it stems from a confined, domestic source: the housing market. This is a sharp contrast to earlier episodes when surging oil prices or the bursting of the new economy and the meltdown of equity markets hit all advanced economies at the same time.

Of course, the housing slowdown will also leave its mark on private consumption in the United States and dampen the rest of the world's exports, especially with the dollar weakening. This will contribute to pushing next year's GDP growth in the euro area and in Japan back down to the trend rate—but not significantly below it.

It is good to see that more and more regions of the world have strengthened their immune systems in recent years and are able to generate robust growth at home. In particular, China and India are expected to grow again by 8.5 percent and 7.5 percent respectively next year. The oil exporters will be fine as well—and countries, like Germany, that supply them with machinery will get some support from this side.

However, some countries have not followed a sensible workout program. For example, I remain concerned about Japan's resilience, as it is again embarking on an investment spree despite the still very murky outlook for long-run returns. In Europe, countries such as Italy and Portugal are quite vulnerable to the U.S. slowdown because their price competitiveness has deteriorated for years. The weakest economies will be hit hardest.

Yes, and that's good news for Americans.

JIM O'NEILL
Head of Global Economics Research for Goldman Sachs

We are living through a period of dramatic change—one of the most exciting in history, economically speaking. The world has been reducing its dependency on the U.S. economy slowly for the past few years. It is little noted, but according to some of our calculations, around of 30 percent of global domestic demand has originated from the BRICs economies (Brazil, Russia, India, and China) since 2000. This is not

as much as the United States, but not far behind. Not only China but India and Russia too have contributed significantly, each accounting for between 5 percent and 10 percent of world growth. China has contributed possibly as much as 20 percent. This has meant that the world's biggest exporters—countries and multinationals—have reduced their dependency on the United States.

Moreover, the "fear of China" has probably been a major factor in driving productivity improvements in some of the "old" economies, including both Germany and Japan. In both, employment has been rising significantly in recent months. We forecast for 2007 that U.S. demand growth will slow to below 2 percent, which is less than one-half of the rate in 2004. For most other regions, the level of demand is likely to be at least as strong as in 2004, if not stronger, and despite the U.S. slowdown, global domestic demand will still be likely more than 3 percent.

We specifically forecast that the BRICs economies will contribute more to world growth from the middle of 2006 through 2007 than the United States. The United States is about 30 percent of the world economy, and the BRICs about 10–11 percent. If they show demand growth of more than 6 percent, that will mean stronger demand impetus for the world than from the United States.

The BRICs story is not just about China, but China is really big. Since 2000, the increase in China's GDP has been about the same as the absolute size of Canada's! Importantly, and not to be lost on American citizens, the reduced dependency on the United States is good news for all, including the United States, not least because many of the world's best exporters happen to be U.S. companies, and the health of the world will likely cushion any further U.S. housing-related slowdown.

The point is that financial markets are increasingly synchronized.

GARY CLYDE HUFBAUER

Reginald Jones Senior Fellow, Peterson Institute for International Economics

It would be a mistake to single out trade flows as the channel for spreading any U.S. slump worldwide. Today financial markets are the main route. U.S. shares account for 52 percent of global equities, and dollar-denominated bonds (wherever issued) account for 37 percent of global bonds. Since financial markets are increasingly synchronized, when Wall Street catches a cold, so do markets as far-flung as Hong Kong, Frankfurt, and Rio de Janeiro. The Anglo-Saxon model that tethers CEO animal spirits to share prices has been embraced worldwide, with obvious consequences for business activity.

If a U.S. slowdown simply reflects a pause in consumer spending, accompanied by a lower Fed funds rate and no more than a modest decline in corporate profits, Wall Street should barely notice and dollar bonds could even rally. That sort of slump will have a weak effect abroad. But if a U.S. slowdown is triggered by a jump in year-on-year inflation, tighter Fed policy will follow, and the story will have a darker ending. U.S. stocks and bonds will drag down financial markets worldwide. Global GDP growth will take a hit right alongside U.S. growth. Emerging markets that have prospered over the past five years will suffer most.

The moral: Don't worry about slower U.S. GDP growth; worry a lot about faster U.S. inflation.

Europe is increasingly less dependent on the United States.

HORST SIEBERT

President-Emeritus of the Kiel Institute for World Economics, Germany, and Heinz Nixdorf Professor in European Integration and Economic Policy, Johns Hopkins, SAIS Bologna Center, Italy

The relative share of the United States in world output has been receding slowly in the last decades. However, with about 28 percent of world GDP, the U.S. economy still has a strong impact on what is happening in other regions of the world. Its sheer demand effect, with which the United States soaks in imports produced elsewhere, is an important stimulating factor for the world.

Accordingly, a reduction in U.S. demand due to slower U.S. growth will slow down exports of other regions. The depreciation of the U.S. dollar is one of the

vehicles through which lower U.S. growth transmits into reduced exports of other countries. The United States also is a major driver of growth in the world economy since it represents the technological frontier in many innovative sectors, including information technology, biotechnology, and modern services due to the United States' dominating position in music, movies, and other services, among them banking and finance and the legal profession in international business contracts.

Europe, with about the same share of world GDP and at the technological frontier only in traditional sectors such as machine building, is busy finding solutions for its unsustainable social security systems in view of an aging population (especially in Germany, France, and Italy). This is why it still has low growth. Even so, Europe is now less exposed to economic changes in the United States. One reason is the euro which allows intra-European exports without exchange rate changes. Another reason is outsourcing and offshoring which have increased the import content of European exports, and these imports now are made easier by appreciations of the euro.

Finally, a reorientation of European exports to the emerging markets has reduced the dependence on events in the United States. Looking into the future, the United States will be at about 20 percent of world GDP in 2030, whereas China will be at 10 percent (instead of 5 percent today). This will continue the process of reorientation in the world economy. However, China so far relies on a catching-up process based overwhelmingly on a strategy of imitation. If the United States can continue to be at the technological frontier of the world economy, it will maintain its strong impact.

The United States economically is no longer as dominant.

ANNE KRUEGER
Special Advisor to the Managing Director and former First Deputy Managing Director, International Monetary Fund

It used to be said that "When America sneezes, Europe catches a cold," when the United States was the dominant economy. It is of course true that whenever any major trading economy—European, American, Japanese, or other—experiences a major slowdown or recession, the rest of the world is affected. But the United States, while still the most important single economy, has a significantly smaller share of world trade and world GDP than it did.

As other industrial countries and emerging markets have increased their share of trade and world GDP, reliance on America as the sole engine for the world economy has greatly diminished, and the contribution to world growth of other industrial countries, and of the Chinese, Indian, and other emerging market economies, has significantly increased.

In the current context, the world economy has just experienced several years of growth at record, and probably unsustainably high, levels. Growth in China, India, and other emerging markets has contributed significantly to that.

Going forward, it is unlikely that the American economy will slow down as much as the dire forecasts suggest and continental Europe and Japan seem to have accelerated their growth. Prospects are that growth in China, India, and other emerging markets will remain solid as well. While world growth would of course be affected by an American slowdown, global growth is by no means as sensitive to changes in the United States as it used to be. While the chopping-up of the value-added chain has increased interdependence, that interdependence covers many economies, and not just that of the United States.

The impact of a U.S. slowdown would be substantial.

JEFFREY E. GARTEN
Juan Trippe Professor of International Trade and Finance, Yale School of Management

I am skeptical of the economic models that say global growth is not seriously affected by a sharp deterioration of economic conditions in the United States. It is inconceivable to me that this could be the case, because the interdependencies of trade, investment, and currencies are just too great, and the linkages among financial markets simply to complex and not well enough understood to make a confident judgement about what would hap-

pen. Of course, it may be that the U.S. economy isn't as influential as it once was, especially with the rise of Asia and the consolidation of the European Union. But my instinct tells me that the impact of a significant American slowdown would still be substantial.

No, the United States is essential.

CRITON M. ZOAKOS
President, Leto Research

No, the world is not becoming immune to America. Last year, China's trade surplus against the United States was the equivalent of 105.4 percent of Chinese GDP growth; the Eurozone's was 70.1 percent; Japan's 66.8 percent; the United Kingdom's 74.8 percent; Mexico's 59 percent; Canada's 56 percent; the oil-exporting countries' 46.5 percent; and Asia/Pacific's ex China and Japan 29.8 percent. Adding up these U.S. contributions to other countries' growth plus the U.S. GDP growth itself, we can, directly and indirectly, attribute to the United States 69.1 percent of world GDP growth in 2005.

This is just a single demand-side measure of other countries' growth dependence on the United States, and not the most important one. More important is the way, on the supply side, that the United States is driving the ongoing revolutionary reshuffling of the worldwide division of labor—the real cause of global growth.

Barring a protectionist Thermidor in our future, the still-ongoing U.S.-centered innovations in information technology and management techniques—from supply-chain management techniques to financial engineering software—will continue to jettison low-value-added activities out of the United States and onto the low-cost labor regions of the world.

With all due respect to Deng Xiaoping, Lee Kwan Yew, Manmohan Singh, and others, without the post-industrial, information-technology-cum-entrepreneurship revolution spreading like a virus out of the United States, their most commendable reforms would not have been enough to mobilize the vast idling reservoirs of human labor in the still-emerging world. When these vast masses of humanity are allowed by their *dirigiste* governments to form demographically and politically dominant middle classes and to generate their own domestic demand, then and only then will the world become "immune from America."

The United States will remain an irreplaceable growth engine.

FRIEDRICH WU
Adjunct Associate Professor, S. Rajaratnam School of International Studies, Nanyang Technological University, and former Director of Economics, Ministry of Trade and Industry, Singapore

My view is that the United States will remain an irreplaceable growth engine for Asia in the foreseeable future. While China's average 9–10 percent economic expansion in the past five years has lifted the growth of its neighbors, China itself is still very dependent on the U.S. market. In 2005, nearly a quarter (21.5 percent) of its total exports was shipped to the United States. Even though other Asian countries have become less dependent on the U.S. market, the latter still absorbed between 10.4 percent (Singapore) and 20 percent (Malaysia) of these countries' total exports. Furthermore, exports to the United States account for as high as 20 percent or more of the GDPs of Hong Kong, Malaysia, and Singapore. The same ratios for China, Taiwan, and Thailand are lower, but still average a not-insignificant 7–10 percent. Last but not least, for many Asian countries, their growing exports of components and parts to China for assembling into finished products also depend on final demand in the U.S. market. Should the latter's demand decelerate or contract, Asian countries' exports to China would also falter.

Just as important, the United States is ranked the largest (for Malaysia, South Korea, and Taiwan) or second largest (Philippines, Thailand, and Singapore) foreign investor in many Asian countries. For these six countries, at least 25 percent of their 2005 total inward foreign direct investment came from U.S. multinationals. A trend, or an abrupt, decline in U.S. foreign direct investment in the region would certainly hurt most Asian economies with significant job losses.

Third, the direction of the U.S. dollar also affects many Asian economies. Collectively, it is estimated that major Asian central banks have amassed huge official foreign exchange reserves in excess of US$2.7 trillion. Most of these reserves have been invested in U.S.-dollar-denominated financial assets. A sharp drop in the U.S. dollar exchange rate would shrink the value of these

reserves significantly. Furthermore, as a major market for many Asian exporters, a decline in the value of the U.S. dollar would raise import prices in the United States and hence dampen consumer demand, which would in turn dent export revenues of Asian economies.

Finally, many Asian stock markets exhibit high correlations with the Dow Jones Industrial Average. The May–June 2006 meltdown in many Asian markets was triggered by the U.S. Federal Reserve's raising of interest rates. Given the high percentage of household ownership of stocks in Asia, market and economic trends in the United States have the power to increase or deplete household wealth in Asia.

As such, the economic fortunes of Asia and the United States will remain significantly intertwined until a time when the Chinese, Indian, and ASEAN economies can reach a stage where their growth can become more driven by domestic consumption, innovation, and investment. That will not happen within this decade.

No. Because there is a limit to how much the United States can borrow and spend.

MAYA BHANDARI
International Economist, Lombard Street Research

We would place America in a global context, and say that the world is not immune to excessive Asian and North European savings—the "Eurasian savings glut." The U.S. "spending spree" has rescued the world from the stagnation that the savings glut would have otherwise caused. But the spree will end before the glut: there is no limit to how much a country can save and lend, but there is a limit to how much it can borrow and spend.

The U.S. spree is forecast to end in 2007, causing stagflation, followed by a hard landing. And the world will not be immune from a U.S. thud next year, because the Eurasian adjustment will take some time—certainly past next year. In 2007 therefore, Asian exporters (China plus the ex-tigers) will be hardest hit. Much of U.S. manufacturing is done in China (and the Pacific trade zone), and net exports account for over half China's real growth, not including the significant support to domestic demand via export workers' wages.

Japan and India will fare better—Japan is the best placed of the Eurasian surplus countries to shrink its savings glut, and India's economy is domestic demand driven rather than export driven, with a current account deficit.

Eurozone economies will also feel the chill, but adverse developments here will be driven more by Europe's own "spree-glut" sub-plot—huge surpluses in Germany and Northern Europe, offset by deficits in the periphery.

And recovery from the coming U.S. hard landing could be slow for all. On the one hand, balance sheets have been pillaged by excess debt and overpriced houses—so the bursting of housing bubbles in the United States, Spain, London, and elsewhere will mean spending will need to be held down to rebuild balance sheets. On the other, supply excesses (such as steel in China) will add to deflation.

It's not yet clear the world can grow without the U.S. consumer engine.

WENDY DOBSON
Professor of Business Economics, Rotman School of Management, University of Toronto, and former Associate Deputy Minister of Finance, Canada

The appearance of other engines, including Asian consumers, Chinese governments and producers, and even European consumers, is inevitable over time. Indeed, for much of the past decade western policymakers have been calling on these economies to contribute to more balanced global growth by stimulating domestic demand and addressing structural problems.

But it is not clear that the world economy yet can grow without the U.S. consumer engine, since that engine is still such a large share of world GDP. The immunity thesis is interesting but probably overstated. We don't yet know the final magnitude of the U.S. housing slowdown and its impact on personal savings and it could be surprisingly large. Will the strong balance sheets of U.S. corporations and accommodative monetary policy offset

the negative impacts? Perhaps, but the flip side of monetary policy accommodation and a weaker U.S. currency is appreciation of the European and Japanese currencies, which implies softness that will offset the growth impacts of rising domestic demand and productivity growth. The Chinese yuan is also beginning to appreciate but the rate of appreciation is likely to be managed at 5 percent per year. Better productivity numbers in emerging market economies and rising potential in Europe and Japan suggest their growth will slow but they will weather successfully a U.S. slowdown.

The rest of the world will also be affected by financial market developments. Financial markets are more tightly linked than product markets and their structures are being changed by new players in ways that are not yet fully understood. None of these economies would be immune from a negative U.S.-generated shock to financial markets or a sharp rise in negative sentiment.

The U.S. economy remains the linchpin.

SUSAN ARIEL AARONSON

Teacher, George Washington University, and author (with Jamie Zimmerman) of* Righting Trade: Public Policies at the Intersection of Trade and Human Rights *(2007, Cambridge University Press)

Although U.S. economic growth is slowing, U.S. economic activity is essential to global economic prosperity. Thanks to warmer temperatures and slightly higher worker compensation, KMart, Saks, and Target consumers are still purchasing record amounts of imported goods and services. America's shopping addiction is creating new growth opportunities in many emerging markets. With such higher growth, producers, distributors, and retailers are learning how to sell to consumers with little disposable income. These new global consumption patterns both reflect and fuel U.S. consumption.

Moreover, the newly emerging markets in Africa, Latin America, and Asia still rely on and benefit from U.S. innovation and competition. After Nicholas Negroponte of the Massachusetts Institute of Technology pioneered the world's first energy-efficient laptop for approximately $100, Microsoft developed a "pay-as-you-go" PC purchasing option for customers in emerging markets. While Negroponte plans to partner with governments to buy these laptops for their citizens, Microsoft's consumers can access the PC using prepaid cards or with a monthly subscription. As consumers in the developing world try these and other options, there will be many positive economic and educational spillovers. I anticipate that these innovations will increase productivity and provide access to new opportunities for more people, akin to the impact of the cell phone in the developing world. In this way, the United States still proves it is central to global economic growth.

As other countries grow, U.S. slowdowns may have less of an impact on their economies. But a drastic downturn could undermine global growth. As shown after the 2001 terrorist attacks, global policymakers have some understanding of how to coordinate economic activity in the face of a huge external shock. Although countries such as China, India, and Brazil are increasing their global economic clout, the United States remains the linchpin of the global economy.

First, the American economy's doing fine. Second, if the U.S. slows, Europe won't receive much of a boost from China.

CHARLES WOLF, JR.,

Senior Economic Adviser and Corporate Fellow in International Economics, RAND

The Economist's editorializing about "keep[ing] Europe afloat" begs a neglected question: why can't Europe do a better job of keeping itself afloat? This isn't a question of autarchy or protectionism, but rather one of why the European Union and its own huge market interacting with the huger global market can't do more to lower its 8–9 percent or higher unemployment rates and raise its 1–2 percent low GDP growth rates without foisting that responsibility on either the Asian or U.S. economies.

In any event, it may not be prudent to expect much of a boost for Europe to come from an upsurge of consumer demand in China. China is trying hard to encourage domestic demand and is achieving some success in

doing so. But it is also trying to meet much of that demand by re-directing increases in domestic production more toward the domestic market and away from exports and the outside market. Its laudable if peripheral aim is to counter external criticism—from both the United States and the European Union—about the frequent and large imbalances in China's international accounts. The result is likely to be only modest increases in China's imports from Europe. There is something of a conundrum here. While domestic consumption in China has been rising significantly, official data on current savings haven't shown any decrease from their normal and strikingly high 35–40 percent of GDP! One possible explanation is that much of the increased consumption may be financed by drawing from the large prior accumulation of bank deposits held by households, businesses, and other organizations. The last time I looked, these liquid RMB holdings amounted to over 24 trillion RMB, more than twice China's GDP! The bottom line is that it's doubtful whether Europe can expect much of a stimulus from increasing exports to China.

While a substantial slowdown in the U.S. economy would surely not be helpful for Europe, that prospect doesn't seem likely. Instead, continued growth at an annual rate of 3 percent or higher seems probable, when one considers the low rate of unemployment, the high rate of corporate profits, and the impressive resilience the economy has displayed in adjusting smoothly to the marked drop in housing.

Perhaps the conclusion from these musings is that Europe ought to do more to keep itself afloat rather than seeking flotation from elsewhere!

Yes, which is why I'm bearish on America, but bullish on the rest of the world.

STEPHEN G. CECCHETTI
Rosenberg Professor of Global Finance, Brandeis International Business School

As the saying goes, will the world get the flu if the United States catches a cold? There are two reasons to think not. The first is that there has been a great moderation, not only in the United States but in much of the industrialized world. For the past decade or so, the volatility of growth has been cut roughly in half. The leading suspect explanation for this is that financial market development has made it possible for individuals to borrow and lend in ways that enable them to smooth their consumption even though their incomes fluctuate. This makes me less concerned overall, as the world's economies are more resilient today than they were in the past. We have all gotten our flu shots.

I am less concerned this time around as well. The primary reason is that growth in the Western Europe is finally rising, and appears to be headed as high as 3 percent. Since there's very little population growth in these countries, this would be equivalent to the 4 percent rate we saw in the United States during the late 1990s. So even if there is a slowdown in the United States (and I believe that trend growth could now be as low as 2.5 percent here), others are in a good position to pickup the slack.

The bottom line is that I'm bearish on America, but bullish on the rest of the world.

Standard macroeconomic simulations are the wrong approach.

BERNARD CONNOLLY
Global Strategist, Banque AIG

It is boring and unenlightening to approach this issue through macroeconometric model simulations: how big a U.S. slowdown; in what sectors; how much of the effect of a U.S. demand slowdown is shifted abroad via dollar depreciation; how global interest rates react; what the trade elasticities are; what the components of monetary conditions do; and so on. These are not the important questions.

With real long-term interest rates apparently below "normal" almost everywhere in the world, global spending has been brought forward from the future. The nature of this distorted intertemporal allocation varies from country to country. But globally there must now be an underlying tendency for demand to fall below potential output. What is supporting global demand in the face of this tendency is an ongoing reduction of risk premiums, massive leverage, and overvalued asset markets.

A U.S. "modified Goldilocks" scenario of just a few quarters of slightly below-trend growth and appropriately reduced inflation—a scenario in which the underlying tendency for demand to fall short of potential was offset by rising stock prices and further falls in risk premiums—would have very little negative global impact on growth. Indeed, if the materialization of such a scenario further buttressed perceptions of "The Great Moderation," with macroeconomic turbulence virtually banished and financial market volatility tamed, then global demand might actually be boosted.

But if a U.S. slowdown were more pronounced or prolonged, that would imply that, at best, the underlying tendency for demand to fall short of output was coming into play—and would probably be reflected globally. At worst, it would betoken a collapse of the precarious global quasi-equilibrium: with leverage so high, risk premiums currently so low, and asset markets so overvalued, this would threaten to bring a repeat of certain early-1930s developments.

This is unlikely—but only because central banks, despite their repeated warnings about the underpricing of risk, would be forced to support markets. Central banks globally are on a conveyor belt that—with a few individual exceptions—they cannot get off without risking a global economic and financial disaster. They could risk attempting to restore some fundamental global equilibrium only if financial market risk had first been socialized and there had been deep and pervasive government interference in markets in general—if a new, crypto-socialist Rooseveltian "New Deal," with all its harmful structural effects, had preceded and forestalled a Great Depression rather than reacting to one.

Nothing's changed.

STEVE H. HANKE
***Professor and Co-Director of the Institute for Applied Economics and the Study of Business Enterprise, Johns Hopkins University, and Contributing Editor,* TIE**

Until recently, the oft-repeated conjecture in the financial press ran along the following lines: economic integration has increased significantly over the past quarter-century, so economic growth will be more highly correlated. This speculation reached the state of "fact" during the near-simultaneous slowdown of the G7 economies in 2001, when virtually every pundit concluded that we had reached an era of synchronized growth rates. The question raised by *The Economist* and posed by *TIE* stands that original conjecture on its head. What a difference five years makes!

Will increased trade and financial integration increase or decrease the correlation among economies? That's the question, but economic theory offers surprisingly little help in answering it. We must rely on empirical evidence. It suggests that, even though economic integration has increased, the growth rate correlations between the United States and other countries have remained about the same for over thirty years, with the movements being most similar when the U.S. economy tanks. This pattern is true even for the United States and Canada, where there has been a dramatic increase in integration since the Canada-U.S. Free Trade Agreement of 1989.

Surprise: the correlation between U.S. economic growth and that of other major economies hasn't changed in any significant way. More importantly, if business cycles (peak-to-trough) continue to become longer, it could be a hundred years before we have enough data to definitively answer the question posed.

The United States will have less impact than previously.

ALLEN SINAI
Chief Global Economist, President, and Co-Founder of Decision Economics, Inc.

In 2006, and probably 2007, the U.S. economy has downshifted to a much lower growth path. In contrast, other global economies, particularly Asia, the Eurozone, and many emerging market countries have picked up speed.

Will the U.S. slowdown, particularly if it worsens, bring down other global economies as it has in the past? Or, has "globalization" somehow altered the historical relationships between the U.S. economy and the rest of the world?

It is unlikely that the U.S. slowdown, or recession if one emerges, will have the same negative effects on the world economy as previously.

There are at least three reasons.

First, the economic geography has changed, with more countries, such as China and India, getting bigger to influence the world economy. The relative importance of countries, particularly the emerging world, is changing, with the United States becoming less dominant and others more so. These economies are expanding on their own and relying less on the United States for growth.

Second, there are increased propensities for trade between countries within regions, such as Asia and the Eurozone, relative to the United States. Here, a particular example is the tight trade ties between countries in the Asia-Pacific region, where China now has become the biggest trading partner of Japan and South Korea, supplanting the United States. In the Eurozone, Germany, France, and Italy always have had close trade ties, but now Eastern Europe is more important, with increased trade between Russia, Hungary, the Czech Republic, Poland, and Germany, thus the Eurozone.

Third, global finance and flows-of-funds move around the world now more freely than ever before, funding opportunities and sensing risks sooner. Funds are flowing to where the opportunities are and providing lifts to economies so that any trouble in the United States will be cushioned by increased funds flows elsewhere.

The impact of any U.S. economic slowdown also depends on the cause—this time focused in U.S. housing and motor vehicle sales as opposed to a slowdown from some generic source like rising oil prices or higher interest rates. If the cause of the U.S. slowdown were a more general phenomenon, affecting the United States and the world, for example generalized weakness in consumption, then bigger impacts on non-U.S. economies might be expected.

Globalization has created the new economic geography and landscape, where the United States, while still an important engine of growth, has become less so. The shifting sands of relative strength and power across the globalized world and globalization of funds flows and technology make for much less chance that a U.S. economic downturn will infect the global economy than in other downcycles.