

[Comment] EU growth can offset the US debt crisis

11.09.2006 - 07:14 CET | By George Irvin

EUOBSERVER / COMMENT - These are dangerous times for the world economy. Rising demand coupled with the prospect of growing supply uncertainty in the Middle East is driving the price of oil towards a \$100 a barrel.

At present, the core countries of the Eurozone are growing slightly faster than last year, but their recovery is still uncertain. Buoyant demand in the United States continues to deliver growth, which in turn continues to keep trade growing in the OECD economies. But just as US domestic demand in the 1990s was driven by stock market exuberance, today it is driven by rising house prices.

The end of the house price bubble coupled with dollar weakness spells serious trouble for Europe.

US household debt

Can the US housing market continue growing and what if the bubble bursts? The good news is that unlike stock market bubbles, housing market bubbles don't burst with a bang. US homeowners won't attempt to sell their houses all at once; prices at first stagnate, then fall slowly.

The bad news is that as consumer demand slows, manufacturing investment slows even more and recession sets in. The bad news for Europeans is that when the US economy sneezes, we catch cold.

To clarify the danger, consider the US housing bubble in more detail. In the United States, low interest rates, tax relief for mortgages and financial deregulation have made it easier for first-time buyers to enter the market and for existing homeowners to turn their appreciating property into ready cash.

Until recently, it cost a mere \$500 a month to repay an 'interest only' mortgage worth \$100,000 at 4% over 30 years. Since workers' real wages in the US have been virtually stagnant for more than a generation, using property to access extra cash has become vital to many Americans. Consumers have been eager to borrow and the financial sector eager to lend - not just the banks but finance and insurance companies have grown rich on repayments and credit has expanded greatly.

Between 1995 and 2005, the median price of a house in the US doubled, way ahead of the rate of inflation. Net household debt is nearly \$12 trillion, and since 2000 most of the increase consists of mortgages.

Why is this dangerous? The problem is that when demand slackens and house prices eventually fall, consumers - starting with the most recent house buyers - find they hold assets worth less than the value of their debt; i.e. they hold 'negative equity'. When they can't repay their loans, the banks are saddled with 'non-performing' assets, and they in turn curtail lending (and in some cases go broke). As the Japanese experience of 1990 illustrated all too clearly, a burst property bubble can cripple an economy for years. EU countries like Spain where property prices have been rising fast would do well to ponder this lesson.

Macroeconomic implications

The net indebtedness of consumers is merely part of the puzzle of US fragility. Household debt now far exceeds corporate savings, which means the private sector is in the red. Bush's tax cuts, although they helped spur US growth after 2001, have left the government in deficit, and these two deficits together are reflected in the US external current deficit which is now the largest in history, \$750 billion in 2005, equivalent to nearly 8% of US GDP and growing at the rate of about \$150 billion a year.

Since the US private and government sectors have ceased saving, it is foreigners who must save - and lend their savings to the US. The Eurozone, Japan, China and various oil producing countries run a current account surplus with the US, which means these countries take in surplus dollars.

The surplus dollars are used to purchase US financial and real assets; the US has moved from being a net creditor to a net debtor to the tune of roughly \$4 trillion. Overseas investment in the US at the end of 2005 probably reached \$14 trillion, about the same as the country's national income.

Most important, the deficit has been increasing despite an effective dollar devaluation of 17 percent over the three-year period 2002-04. If adjustment is sought by recourse to devaluation alone, then it is clear

that much larger effective devaluation is needed. But a very large devaluation would most likely be accompanied by a US - and thus a world - recession.

Devaluation, moreover, is unlikely to be voluntary; on the contrary, a run of the dollar could be set off by any number of events. A further oil price rise (say, spurred by fear of a strike against Iran) would lead financial markets to expect the Fed to choke off the inflationary danger by raising interest rates, thus squeezing the housing market. Or suppose China decided to convert much of its dollar holdings into euros? Indeed, financial markets need only believe that a crisis may occur in order for a real crisis to occur.

Engineering a soft landing means faster EU growth

Engineering a soft landing for the dollar will not be easy, particularly as neither the US government nor the IMF appear to think strong corrective action is required. By contrast, most economists involved in this debate believe that at least three things are needed.

First, US interest rates need to be nudged up gently to take the steam out of the housing market without precipitating a loss of confidence (which is already happening). Secondly, agreement is needed between the world's finance ministers - along the lines of the 1985 Plaza Accord - to effect an orderly and effective devaluation of the dollar.

Most important, if the US economy will need to grow more slowly in order for import demand to fall, the rest of the world needs to grow more quickly to absorb extra US exports and offset deflationary pressure on the world economy. But China and the rest of Asia cannot realistically grow much faster. The key player is the eurozone, which accounts for a quarter of world GDP.

Brussels and Frankfurt would do well to ponder this lesson. Given the fragility of the international economy, deflationary monetary and fiscal policy in the eurozone is the last thing the world needs!

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