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## AMERICA'S ECONOMIC SLOWDOWN THREATENS THE GLOBAL ECONOMY: THE OUTLOOK FOR GLOBAL TRADE

Preliminary figures indicate that America's GDP expanded at a 1.9 percent annual rate in the second quarter of this year. Although the nation appears to be skirting a recession, its protracted economic weakness is hurting many of its trading partners. Their inability to "decouple" from the slowing U.S. economy is one of the downsides of a globally linked economy. This article reviews the current state of the global economy, discusses the economic outlook for America's key trading partners and explores the best trade opportunities for local businesses.



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### America's Influence on the Economy

America has been the world's "consumer of last resort" for decades. The voracious appetite of U.S. consumers allowed emerging economies to grow and prosper by helping to support their exports. The collapse of the U.S. housing bubble and the credit market turmoil that ensued caused American consumers to retrench. As a result, Americans bought fewer imports and export-dependent economies around the globe are feeling the chill.

The global integration of financial markets sped America's housing crisis and credit market problems around the globe. U.S. subprime mortgages showed up on the books of financial institutions in other countries and these institutions responded by tightening credit. Housing markets in Ireland, Spain and Britain, which also soared in the past decade, are coming back to earth. Real estate prices in India and southern China are no longer rising. Sales of apartments in Hong Kong have slowed. Real estate prices have fallen by more than 20 percent in New Delhi

and other parts of northern India in the past year. While fast-growing economies like China and India may be only marginally affected by America's economic problems, other trading partners face the prospect of actual recession.

#### The European Union: Preparing for a Hard Landing

The 15-nation euro zone is the world's second largest economic entity. Its annual output is about \$12.2 trillion. Germany accounts for more than a third of euro-zone output. An estimated 47 percent of Germany's economy is dependent on exports. The strong euro combined with high raw material prices and slowing global growth have hurt German manufacturers and put a dent in their exports. Orders from the rest of Europe have declined, as have orders from Asian and Latin American customers whose growth is dependent on exports to the United States. French consumer spending is faltering because of rising inflation and a weaker housing

market. Investment in residential housing accounts for almost 10 percent of Spain's GDP and the implosion of Spain's housing boom threatens to push the country into recession. Spain's unemployment rate was at a three-year high of 10.4 percent in the second quarter of this year.

Slower euro-zone economic growth has been accompanied by rising inflation. The zone's inflation rate hit 4.1 percent in July, its highest level since records were kept starting in 1997. In response, the European Central Bank raised its key interest rate to 4.25 percent in July. The bank expects the euro-zone economy to expand by 1.8 percent this year and by 1.5 percent next year. This projection may be optimistic, given the bank's emphasis on fighting inflation by raising interest rates.

#### The United Kingdom: Hurt by Turmoil in Financial Markets

The United Kingdom has the world's fifth-largest economy. It has

experienced 15 years of uninterrupted economic growth, largely due to the global credit boom. London has become a major global financial center. The financial sector currently accounts for more than one-fifth of UK jobs. The growing economic dependence on finance-related jobs has begun to hurt the UK economy, which grew by only 0.2 percent in the second quarter of this year. Ongoing problems in global financial markets have eliminated thousands of well-paid UK jobs in finance. Moreover, UK home prices are falling at the fastest pace in more than a decade as mortgage credit dries up. June home prices were 6.1 percent below their level of a year ago. Consumer debt is also a problem. Consumers splurged during the recent economic boom. Consumer debt stood at 164 percent of disposable income at the end of 2006, the highest ratio of any developed country. Falling home prices and high consumer debt levels are hurting consumer spending, which accounts

for more than two-thirds of the UK economy. Inflation is another problem. The UK inflation rate stood at 3.8 percent in June, well above the Bank of England's target of 2 percent. Given these circumstances, the June unemployment rate, 5.1 percent, could reach 6 percent by next year. Britain's central bank reduced its main interest rate three times since last December and further rate reductions are expected. However, the nation's large budget deficit would appear to preclude a fiscal stimulus package.

#### Asia's Economies: Beginning to Slow Down

Asian exporters are clearly feeling the effects of the U.S. economic slowdown. Some Asian companies experienced a 10-to-20 percent decline in orders in the second half of 2007. There is growing concern that most Asian countries have not been able to decouple from the U.S. economy. China has benefited to some extent

from slower exports to the U.S. because it has been struggling to contain its overheated economy. However, for export-dependent countries like Japan, Malaysia, Thailand, Australia, Bangladesh, Sri Lanka, Cambodia and Indonesia, reduced U.S. demand for their products has become a major problem.

**Japan.** Japan is highly export-dependent. Exports accounted for 55 percent of its GDP in 2007. Japan is being buffeted by a combination of falling exports and higher food and energy prices. In the past year, Japan's exports to the United States declined by 15 percent and its exports to Europe were down by 11 percent. Japan's exports to the rest of Asia rose by only 1.5 percent in the past year, well below the 16.0 percent increase of the prior year. Moreover, demand from other Asian countries is expected to shrink as these countries raise interest rates to contain inflation and demand from their consumers declines.

**China.** Although China's economy is beginning to slow, it is still expanding at a torrid pace. GDP growth in the first half of 2008, 10.4 percent, was only a fraction less than comparable growth in 2007, 11.9 percent. However, China remains highly dependent on exports for growth. China's global trade surplus surged 48 percent in 2007 and its foreign exchange reserves are now the world's largest. Moreover, rapid growth has been accompanied by inflation. China's July consumer price index was 6.3 percent above a year ago. China's central bank recently sig-

#### Projected Economic Growth, Selected Countries

Country/Zone	2006	2007	2008(p)	2009(p)
Euro Zone (15)	2.8%	2.6%	1.7%	1.2%
Germany	2.9	2.5	2.0	1.0
France	2.2	2.2	1.6	1.4
Italy	1.8	1.5	0.5	0.5
Spain	3.9	3.8	1.8	1.2
Japan	2.4	2.1	1.5	1.5
United Kingdom	2.9	3.1	1.8	1.7
Canada	3.1	2.7	1.0	1.9
Central/Eastern Europe	6.6	5.6	4.6	4.5
China	11.6	11.9	9.7	9.8
India	9.8	9.3	8.0	8.0
Mexico	4.9	3.1	2.4	2.4
Brazil	3.8	5.4	4.9	4.0
United States	2.9	2.2	1.3	0.8
<b>World</b>	<b>5.1</b>	<b>5.0</b>	<b>4.1</b>	<b>3.9</b>

(p) Projected; Source: International Monetary Fund, July 2008

naled that monetary policy would focus on maintaining economic growth rather than curbing inflation. This suggests that it may loosen recently imposed credit curbs and slow the appreciation of its currency, the yuan. The yuan rose by 6.9 percent against the U.S. dollar in 2007, making Chinese exports more expensive abroad. China is concerned that any appreciable economic slowdown could lead to job losses that would be socially disruptive.

**Singapore.** Singapore's economy has been hurt by its relatively strong currency and by faltering demand from abroad for its electronics and pharmaceuticals products. Singapore's exports to the United States fell by 22 percent in the past year; its shipments to the European Union were down by 28 percent. Singapore's inflation rate is currently 7.5 percent, the highest in 25 years. Singapore has allowed its currency to appreciate and is relying on a strong currency to contain inflation. This automatically makes its exports more expensive abroad. Although Singapore's economy expanded by 7.7 percent in 2007, growth is expected to slow to between 4 and 6 percent this year.

**India.** India has been the world's second fastest growing major economy after China. Its GDP increased by 9 percent in fiscal 2008, which ended March 31, 2008. GDP growth is expected to slow to between 7.0 and 7.5 percent in the current fiscal year. India's inflation rate recently hit a 13-year high. Wholesale price inflation could reach 15 percent this fall, more than double the central bank's comfort level of about 5.5 percent. In response, the Reserve Bank of India recently raised its key short-term

interest rate to 8.5 percent and increased the amount of cash reserves that banks must keep on hand. The government's large fiscal deficit, estimated at 11.4 percent of GDP in the current fiscal year, will curb much-needed investment in India's deteriorating infrastructure. India urgently needs to modernize its ports, roads, power systems, airport and telecommunications infrastructure in order to sustain rapid economic growth. An estimated \$500 billion in infrastructure spending is needed over the next five years.

**South Korea.** Although South Korea is still experiencing strong export growth, its economy is clearly slowing. Second quarter 2008 exports were almost 12.0 percent higher than a year ago and export growth is expected to continue. However, GDP growth is slowing as a result of declining consumer expenditures. Consumer demand contracted for the first time in four years in the second quarter of this year, just as inflation accelerated. South Korea's June inflation rate was 5.5 percent. This is well above the central bank's target inflation rate of between 2.5 and 3.5 percent. Although the Bank of Korea kept its key base interest rate steady at 5 percent in July, it is expected to tighten monetary policy to tame inflation.

#### **Latin America: Helped by Surging Commodity Prices**

The economies of Argentina and Brazil stand in sharp contrast to each other. Argentina, which has price and export controls, is struggling to contain inflation and is facing a revolt by its farmers. Brazil, South America's

largest economy, is experiencing its biggest economic expansion in three decades.

**Argentina.** Argentina's economy has grown at an average of more than 8 percent annually during the past five years. Growth was spurred by high global prices for its agricultural commodities. Argentina is the world's second largest source of corn and the fourth largest source of soy. However, its economy is being hobbled by surging inflation due to higher food costs and rampant government spending. Its real inflation rate is believed to be three times the official inflation rate of 8 percent and its currency, the peso, is depreciating. In 2001, Argentina defaulted on its sovereign debt and devalued its currency. Although it currently has almost \$50 billion in foreign reserves with which to defend its currency, there is growing concern that Argentina may devalue the peso in order to protect local industries from import competition.

**Brazil.** Brazil has a diversified industrial base, a booming agricultural sector and a large pool of untapped natural resources. Its 185 million people constitute a large domestic market and it has a growing middle class. Brazil's exports include soybeans and iron ore. Moreover, exports to the United States represent only 2.5 percent of its GNP so that Brazil is unlikely to sustain significant economic damage from the U.S. economic slowdown. Brazil's economy has been growing at a 5.0 percent annual rate for the second year in a row. Whereas Brazil was on the verge of a massive debt default in 2002, it now has enough U.S. dollars to offset its entire foreign debt. In fact, it has become a net creditor nation for the first time in its history. Brazil still has

an overly large public sector. As a result, its tax burden is equivalent to 36 percent of its output. However, on balance, Brazil has come a long way economically.

### The Future of World Trade

The DOHA round of world trade talks, which started in 2001, recently broke down over demands by India and China for safeguards for their farmers. This ended any hope of a global trade deal that would further open markets, cut farm subsidies and strengthen the international trading system. The focus will now shift to trade agreements between two or more countries instead of global accords under the 153-member World Trade Organization. U.S. trade negotiators will focus on winning congressional approval for pending bilateral free-trade deals with Colombia, Panama and South Korea.

The breakdown in negotiations comes at a time when economic growth in the industrialized world has slowed dramatically. (See Table 1) Moreover, there are growing calls for protectionism in both the United States and Western Europe. Protectionist sentiment is gaining momentum in part because of the belief that the gains from free trade are going to a small group of top earners.

The failure of the DOHA negotiations is regarded as a setback for many of the world's emerging economies. However, some of these nations are doing better economically than they did in the recent past. Unlike the 1990s, when several emerging countries defaulted on their sovereign debts,

many of them now have the foreign reserves to help them weather the economic slowdown in the industrialized world. In fact, several emerging economies have been growing at annual rates of 7 percent or more, double the rate of growth of the major industrialized nations.

Nevertheless, the world's emerging economies will not remain unscathed by economic problems of the industrialized world. Much of their recent prosperity has been predicated on exports to the United States and Western Europe. Taiwan, Singapore and South Korea, which export semiconductors and other high-technology goods, are particularly exposed to U.S. consumers. Approximately 23 percent of Mexico's annual output comes from exports to the United States. Eastern Europe is almost completely dependent on trade with the western world. For example, Slovakia's exports account for 70 percent of its GDP.

The surging Chinese economy may help to sustain economic activity in

the resource-rich countries of Latin America, Africa and Southeast Asia. This, in turn, will keep global commodity prices high for the foreseeable future. However, the fact that the U.S. accounts for more than 22 percent of the global economy and that Japan, Germany, France, Italy, Spain and the U.K. collectively account for an additional 24 percent means that the developing world will experience significantly slower economic growth in the foreseeable future.

To the extent that their growth remains sufficient to allow them to pursue their ambitious infrastructure plans, major U.S. multinational firms will clearly benefit. These firms should have ample opportunities to build the roads, sewers, dams, airports and railroads that the emerging nations need to support future economic growth. U.S. firms providing high-end professional and business services should also benefit as the economies of the emerging nations mature and their financial markets deepen.

**Projected GDP Growth,  
Selected Countries, 2009**  
(percents)

