America's vulnerable economy

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Recession in America looks increasingly likely. Can booming emerging markets save the world economy?

IN 1929, days after the stockmarket crash, the Harvard Economic Society reassured its subscribers: "A severe depression is outside the range of probability". In a survey in March 2001, 95% of American economists said there would not be a recession, even though one had already started. Today, most economists do not forecast a recession in America, but the profession's pitiful forecasting record offers little comfort. Our latest assessment suggests that the United States may well be heading for recession.

Granted, GDP grew by a robust 3.9%, at an annual rate, in the third quarter. Granted also, revisions may well push this figure up. But that was the past. More timely signs suggest that the economy could stall in this quarter. By early next year, output and jobs could be shrinking. The main cause is the imploding housing market. Experts said that house prices could never fall nationwide. But fall they have, by 5% in the past 12 months. Residential investment has collapsed, but a glut of unsold homes means that prices have much further to drop. Americans' spending is likely to be dented much more by a fall in house prices than it was in 2001 by the stockmarket's collapse. With house prices lower and credit conditions tighter as a result of the subprime crisis, households can no longer borrow against capital gains to support their spending.

Dearer oil is set to squeeze households further. Consumer confidence has already fallen sharply. It cannot be long before consumer spending stumbles, which in turn would hurt companies' profits and investment. The weak dollar will boost exports, but at only 12% of GDP, exports are too small to make up for a weakening of consumer spending, which accounts for 70%.

I want to break free

Will an American recession drag the rest of the world down with it? The economies of Europe and Japan rebounded strongly in the third quarter, but look likely to slow down. Although both should be able to keep chugging along, neither is likely to set any great pace. Strengthening currencies will hurt exporters in both places. Europe's own housing hotspots are cooling, and some of its banks have been sideswiped by America's subprime ills.

The best hope that global growth can stay strong lies instead with emerging economies. A decade ago, the thought that so much depended on these crisis-prone places would have been terrifying. Yet thanks largely to economic reforms, their annual growth rate has surged to around 7%. This year they will contribute half of the globe's GDP growth, measured at market exchange rates, over three times as much as America. In the past, emerging economies have often needed bailing out by the rich world. This time they could be the rescuers.

Of course, a recession in America would reduce emerging economies' exports, but they are less vulnerable than they used to be. America's importance as an engine of global growth has been exaggerated. Since 2000 its share of world imports has dropped from 19% to 14%. Its vast current-account deficit has started to shrink, meaning that America is no longer pulling along the rest of the world. Yet growth in emerging economies has quickened, partly thanks to demand at home. In the first half of this year the increase in consumer spending (in actual dollar terms) in China and India added more to global GDP growth than that in America.

Most emerging economies are in healthier shape than ever. They are no longer financially dependent on the rest of the world, but have large foreign-exchange reserves—no less than three-quarters of the global total. Though there are some notable exceptions, most of them have small budget deficits (another change from the past), so they can boost spending to offset weaker exports if need be.

This does not mean emerging economies will grow fast enough to make up for the whole of a fall in America's output. Most of them will slow a bit next year: for instance, China's growth rate may dip to "only" 10%. So global growth will ease—which, after five years at an average of almost 5%, close to its fastest pace ever, it needs to do. But thanks to the vigour of the new titans, it will stay above its 30-year average of 3.5%.

A tale of two prices

The rising importance of the world's new giants will not only boost growth. It will also shift relative prices, notably those of oil and the dollar. And the consequences of this will be less comfortable for developed countries, especially America.

The oil price has risen mainly because of strong demand in emerging economies, which have accounted for as much as four-fifths of the total increase in oil consumption in the past five years. In past American recessions the oil price usually fell. This time it is likely to hold up. That will not only hurt the finances of Western consumers, but may also make the jobs of their central bankers harder, by combining inflationary pressure with economic slowdown.

The enfeebled dollar—lately in sight of $1.50 to the euro—would be weaker still without enormous purchases by central banks in emerging economies. This support is now waning. China and others are putting a smaller share of increases in reserves into the American currency. And Asian and Middle Eastern countries with currencies linked to the dollar are facing rising inflation, but falling American interest rates make it harder to tighten their own monetary policy. They may have to let their currencies rise against the sickly greenback, meaning they will need to buy fewer dollars. More important, as international investors wake up to the relative weakening of America's economic power, they will surely question why they hold the bulk of their wealth in dollars. The dollar's decline already amounts to the biggest default in history, having wiped far more off the value of foreigners' assets than any emerging market has ever done.

The vigour of emerging economies is good news for the world economy: for its growth, it has much less need of a strong America. The bad news for America is that this, in turn, may mean that the world also has less need of the dollar.