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RAPIDLY COOLING U.S. HOUSING MARKET COULD TRIGGER GROWTH RECESSION, NEW LEVY ECONOMICS INSTITUTE STUDY SAYS

Boosting U.S. Export Demand through Orderly Dollar Devaluation and Other Internationally Coordinated Policies Is Crucial Given Inevitable Pullback in Private Spending, Levy Macro Team Says

ANNANDALE-ON-HUDSON, N.Y.—With the current account deficit continuing to soar to record levels and all indicators showing an increasing slump in the housing market, the U.S. economy faces serious challenges. Federal Reserve Chairman Ben S. Bernanke continues to stress the dangers of inflation, but has cautioned that the weakness in the housing market could still "turn out to be more severe and widespread" than it now appears. Meanwhile, Bernanke plans to go to China with Treasury Secretary Henry M. Paulsen Jr. later this month, in an unusual move aimed at spurring policies to reduce China's huge trade imbalances with the West. As policymakers continue to wrestle with these issues, a new study from The Levy Economics Institute of Bard College argues that the recession dangers posed by a housing-triggered pullback in private spending outweigh concerns about inflation, and that efforts to induce a controlled devaluation of the U.S. dollar and boost demand abroad are essential to averting a potential global slowdown.

In their Strategic Analysis, *Can Global Imbalances Continue? Policies for the U.S. Economy*, the Levy Institute's Macro Modeling Team—President Dimitri B. Papadimitriou and Research Scholars Gennaro Zezza and Greg Hannsgen—argues that the downturn in U.S. housing is accelerating and threatens to undermine an economy that has been driven by household deficit spending. "Never before has an economic expansion been so dependent on home equity loans and cash out mortgage refinancing," they write, stressing their concern that, faced with unsustainable levels of debt and debt-service ratios, U.S. households must cut spending, a move that will trigger a recession in which many of

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those households will be unable to meet their financial obligations.

To illustrate their concerns, the Levy scholars explore three scenarios for the U.S. economy. In order to meet Congressional Budget Office (CBO) projections for a annual growth rate of 3.5 percent in 2006 and 3 percent from 2007 to 2010, the authors estimate that the private deficit, fueled by household borrowing, would, after a slight decrease, have to begin rising again after 2007—a scenario the macro team considers highly unlikely, given household debt levels and the slowing housing market. Furthermore, in the same scenario, the current account deficit would hover near 6 percent, leading to a level of debt to GDP of 50 percent by 2010. In the second scenario, the scholars analyze the impact of a retrenchment in private spending (roughly 8 percent of GDP), which would bring borrowing down to its early 1990s level and stabilize household debt. Under these conditions, the authors forecast a moderate growth recession, with GDP falling below 2 percent through 2007, then rising to about 2.3 percent. Unemployment could become a much more serious problem in this scenario. The current account deficit would improve to 4.4 percent.

Hoping to generate a more favorable result for the U.S. economy, the macro team explores a third scenario, which looks to boost export growth as a means of sustaining growth and unraveling structural imbalances. In this scenario, the authors assume more optimistic growth for the rest of the world and a 10 percent devaluation in the dollar, each year for the next two years against the pound and euro and a 5 percent per year devaluation against the Chinese yuan and other Asian currencies. Assuming the dollar devaluation will not have an adverse effect on inflation in the United States, the authors contend that such a scenario would see GDP growth drop to 1.6 percent, but return toward its trend level (around 2.8 percent) much more rapidly. Furthermore, the current account moves toward balance, rising from negative 6.3 percent in 2006 to negative 3.4 percent by 2010. The private sector balance recovers to negative 0.9 percent in 2010. To conclude, the authors contend that the slowing housing market makes a downturn in private spending inevitable, and that policymakers must explore an orderly dollar devaluation and other internationally coordinated fiscal and monetary policies to avert a recession.

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Strategic Analysis: *Can Global Imbalances Continue? Policies for the U.S. Economy*

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