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U.S. economy should avoid Japan woes


By Mark Zandi, November 30, 2014

Japan is in recession, the eurozone is flirting with one, and China and much of the rest of the emerging world are at best holding their own. Will the U.S. economy be undermined by events overseas, or is it strong enough to keep the global economy moving forward?

Japan's problems are nothing new. The world's third-largest economy after the United States and China has been in and out of recession for the last quarter-century and has yet to free itself from the dark pull of deflation (falling prices).

The Bank of Japan has been trying much harder recently, gunning the monetary accelerator by buying bonds and stocks to get the economy moving. The value of the yen has fallen sharply in response, and there are some signs that inflation and wage growth have turned up.

But Japanese policymakers botched it when they raised the sales tax in the spring. The nation has a massive fiscal problem, which they hoped the sales-tax hike would address. Instead, it spooked consumers and pushed the economy back into recession.

This highlights a key difference with the United States, where, despite the political brinkmanship, policymakers aggressively responded to the Great Recession with massive monetary and fiscal stimulus.

The Federal Reserve quickly pushed short-term interest rates to zero and started buying bonds to get long-term rates down. Congress and the Obama administration temporarily cut taxes and ramped up government spending. It worked to quickly end the recession, and the U.S. economy is coming up on six years of consistent growth.

Europe also has big economic problems. The plunge in oil prices and the weaker euro will likely stave off a third recession in seven years, but just barely. Italy and France are in recession, and even the stalwart German economy is struggling.

The Russian incursion into Ukraine and the resulting Western economic sanctions on Russia have hurt badly. However, the most serious weight on the eurozone is the lack of fundamental reform of labor and product markets, especially in Italy and France. Until these countries make big changes, it is hard to see the eurozone economy breaking out of its funk.

Deflation is a serious threat, especially given the European Central Bank's stilted response to it, at least so far. The ECB recently adopted a negative interest rate and has begun buying bonds, but it has significantly lagged efforts by the Fed and Bank of Japan.

There are growing calls for the ECB to go all the way and buy bonds issued by the countries that make up the eurozone. But the political bar for doing this is high, and there are reasonable arguments that it would provide less of a boost to the eurozone economy than such moves have in the United States and Japan.

With unemployment firmly into double digits and wages falling throughout much of Europe, political discord is quickly building. Fringe political parties are gaining traction, including the AfD in Germany, the National Front in France, Podemos in Spain, and UKIP in Britain.

Nothing would spook global investors more than if one of these parties appeared likely to gain control of a government, as most are very skeptical about remaining in the eurozone and paying on their nations' sovereign debt.

Odds that the European debt crisis is not over and that more financial market turmoil will emanate from the region are consequential.

China's economic juggernaut has also weakened. Chinese officials understand they have serious structural problems: overbuilt real estate markets, lots of bad loans by their banks, unproductive state-owned companies, over-indebted local governments, corruption, environmental degradation, and more.

Fixing these problems will be daunting, but officials are trying, at least to a point. As soon as it looks as if their reform efforts are hurting economic growth too much, they pull back on them. Growth has slowed, but this is largely according to plan. They couldn't hope to grow at the breakneck speed of recent years.

However, it is not hard to envisage a scenario where they stumble, badly. It's difficult to balance reform with growth. If they don't, and growth slows too much, this will be a huge hit, particularly to the rest of the emerging world that relies heavily on Chinese demand for their goods and commodities.

With much of the global economy in such trouble, it is reasonable to wonder whether the U.S. economy can avoid problems.

It should. The U.S. economy's links to the rest of the world, while significant, are small in the broad scheme of things. Exports account for less than 15 percent of U.S. gross domestic product. Suppose the world suffered a significant recession next year in which GDP fell by 1 percent. The direct impact on U.S. growth would be less than a quarter of a percentage point.

This clearly understates the fallout on the U.S. economy, but it highlights that it would take a very serious problem in the rest of the world to hurt the U.S. expansion.

Moreover, the economy is gaining strength as businesses are finally hiring and investing with some gusto. The job market is quickly tightening with the pickup in employment, and wage growth is reviving. The increased income will support more spending and fuel even more business expansion. The U.S. economy is off and running.

There are many other clear threats to the U.S. economy. ISIS-spawned terrorism is a concern, Russian President Vladimir Putin could double down in Ukraine, and the potential for a conflict with Iran over its nuclear program remains. And there is Ebola.

But risks always exist, and in some respects the current ones seem less formidable than those we have grappled with since the financial collapse and Great Recession. Of course, things could still go off the rails, but for the first time in many years it feels as though the U.S. economy is firmly on the tracks.