Press Points for Chapter 4: ***Decoupling the Train? Spillovers and Cycles in the Global Economy***

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Key Points

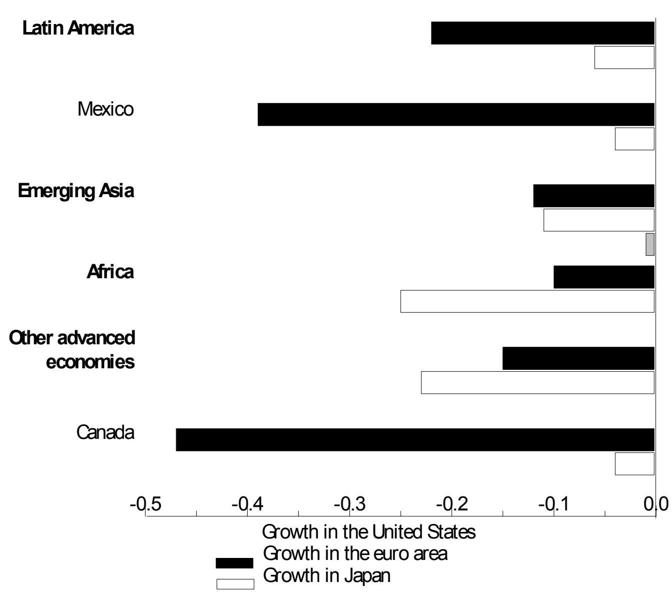
- **A slowing U.S. economy can exert spillovers on growth in both advanced and developing countries, affecting in particular countries with which trade and financial linkages are large.**

- **With the U.S. slowdown to date largely driven by the cooling domestic housing market, spillovers to growth elsewhere have been limited. If the housing market downturn spread to consumption and business investment, however, then cross-border spillovers could be significantly larger, although still manageable provided affected countries respond promptly and flexibly.**

- **Past episodes of synchronized growth slowdowns across the globe reflected common factors simultaneously affecting many countries, rather than country-specific events, such as a U.S. housing market downturn.**

The analysis in Chapter 4 shows that the old saying, "If the United States sneezes, the rest of the world catches a cold," remains relevant: disturbances to U.S. growth do influence growth elsewhere. Moreover, the potential size of growth spillovers from the U.S. has increased over time, consistent with the notion that greater trade and financial integration magnify the cross-border effects of disturbances.

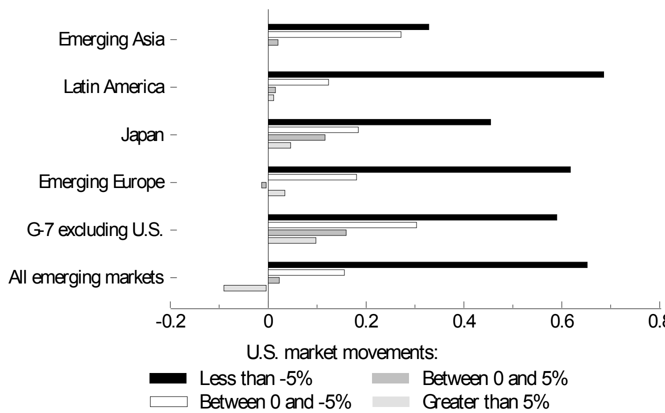
Growth Declines and Spillovers: Regional Implications
(Impact of a 1 percentage point decline in growth rates of euro area, Japan, and the United States)



That said, the importance of growth spillovers should not be exaggerated: their estimated magnitudes, as measured by the declines in output growth, are generally considerably smaller than the output slowing in the United States itself. Spillovers are most important for countries with close trade and financial ties with the United States, particularly Latin America and some industrial countries. On average, a 1 percentage point reduction in annual U.S. growth is associated with a growth decline of 0.2 percentage points in Latin America, and 0.4 percentage points or more in Mexico and Canada (first figure). In contrast, spillovers are quite small for Africa and the Middle East. There is also evidence that the potential size of growth spillovers from the U.S. has increased over time, consistent with the notion that greater trade and financial integration magnify the cross-border effects of disturbances.

Spillovers are larger during full-blown U.S. recessions than during mid-cycle slowdowns. In part, this arises because U.S. import growth turns sharply negative during recessions, and cross-country asset price correlations increase significantly during financial market downturns (second figure).

Correlation Between Domestic and U.S. Stock Market Returns, 1991–2006



That said, previous episodes of highly synchronized growth declines across the world were primarily the result of global developments, rather than U.S.-specific developments spilling over to other countries. For instance, the global downturns in the mid-1970s and the early 2000s were primarily the result of the first oil price shock and the bursting of the IT bubble, respectively.

Policy responses can moderate or amplify the spillover effects of disturbances in the U.S. (or other large economies). Forward-looking monetary policy responses and flexible exchange rates have tended to reduce the output response to adverse demand disturbances, whether foreign or domestic. In contrast, monetary policy responses that are not sufficiently forward-looking or flexible risk magnifying spillovers.

Turning to the current conjuncture, if the U.S. slowdown continues to be largely driven by the cooling domestic housing market, spillovers to growth elsewhere should remain limited, particularly with activity in Europe strengthening. Nevertheless, if the housing market downturn spreads to consumption and business investment, then larger cross-border spillovers could be expected. In that case, policymakers would need to respond in a flexible, forward-looking and timely fashion to help cushion the impact of weaker external demand.