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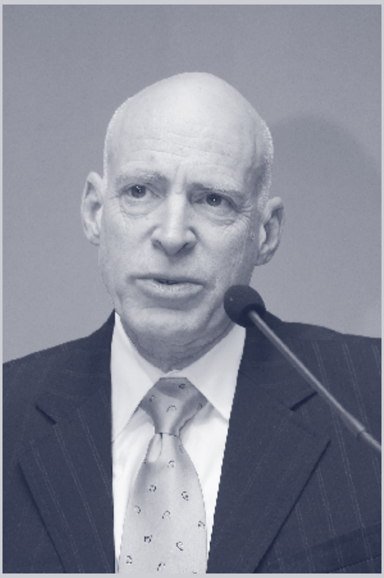


EMU, the Euro and Europe's Role in the World Economy – A Transatlantic Perspective

Despite what you may have heard, the United States is not in the Great Depression. Indeed, the indicators that we currently have suggest that we probably are not even in a recession, at least not by historic standards.

Chart 1 shows the five indicators that the National Bureau of Economic Research has used historically to date recessions. Only retail and manufacturing sales are declining at rates commensurate with prior recessions. Job loss, while an unwelcome development, is less than half the rate that prevailed during the mild recession of 2001. Neither Industrial Production nor Personal Income indicators are in the recession range. Monthly GDP is a volatile series and at worst earns a "maybe."

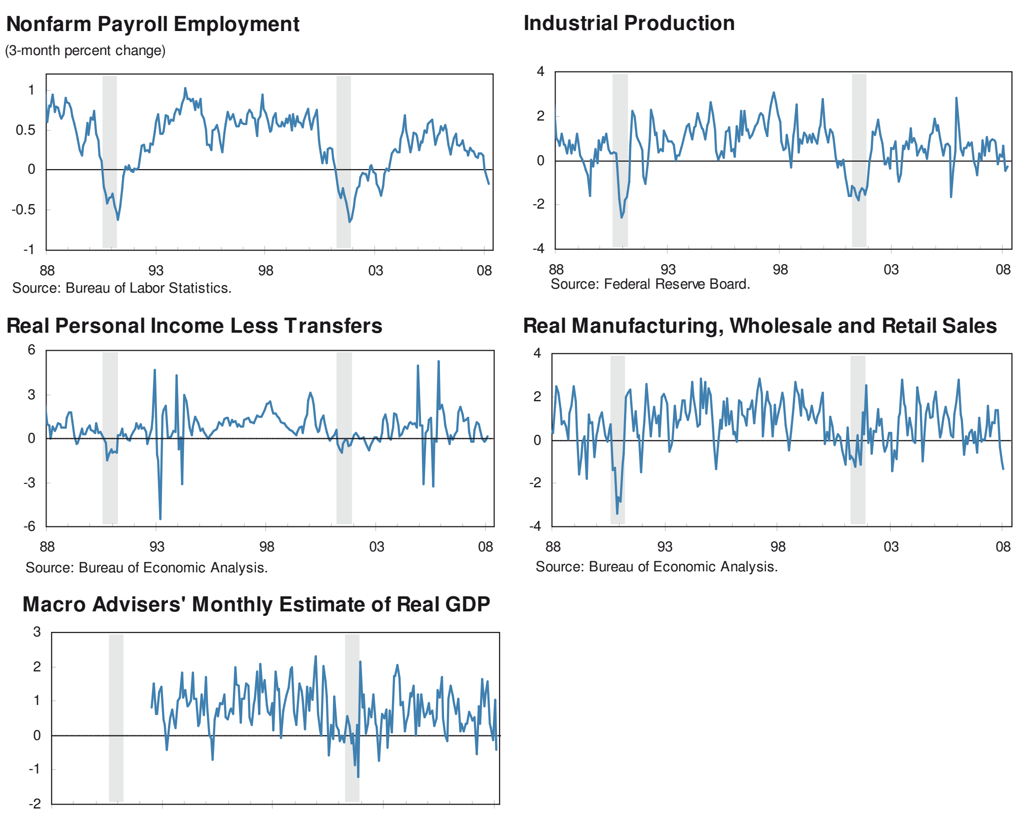
Still, the first quarter of 2008 was not a good period for the U.S. economy. We expect to have had near zero, probably slightly negative growth last quarter, but the economy is still moving and unemployment is still low at 5.1%.

Most observers believe that the weak growth in the fourth quarter of 2007 will be followed by weak growth in the first half of 2008. Low growth forecasts are common right now.

Additionally, the President signed an economic growth package in February that was proposed by the Administration. This will help stimulate the economy in the near term.

Why did the President feel that it was necessary to act? After all, we saw

Chart 1



0.6% growth in the first quarter of last year and did not propose any stimulus package at that point.

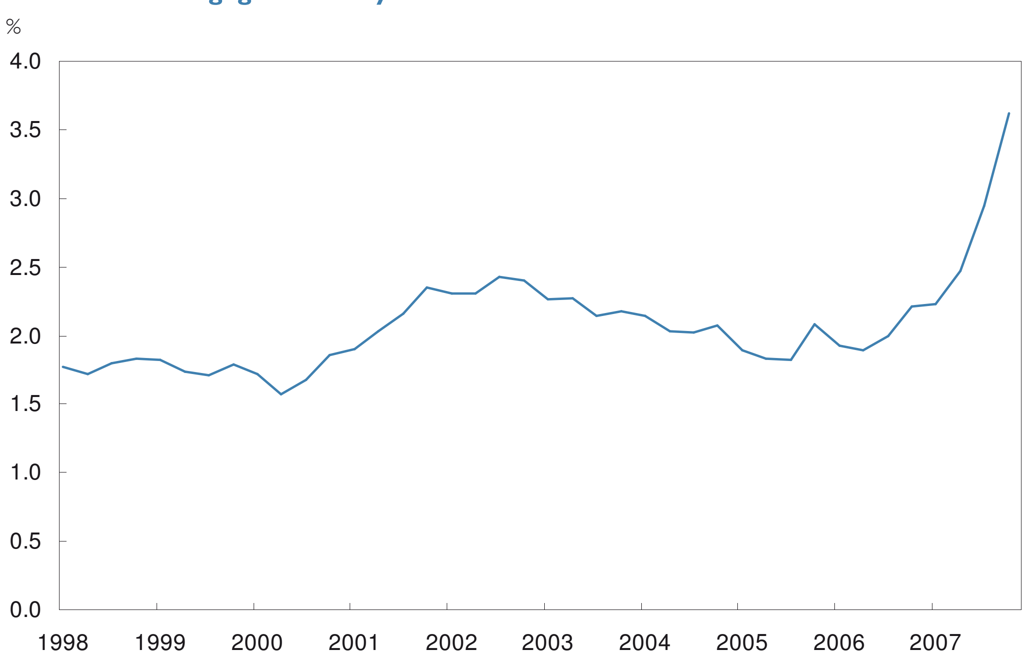
Conditions are different right now than they were a year ago. Part of this is the continued decline in the housing market, which most did not forecast. It is important to recognize, however, that the housing decline is not new. This is a continuation of the trend that started in earnest about 8 quarters ago. But the rise in mortgage foreclosures is a new phenomenon. As shown in chart 2, there was a rise in foreclosure rates that began in mid-2006 that became an apparent deviation from the norm by mid-2007. The jump is substantial, from a low of about 2% of all mortgages 90 days past due or in the process of foreclosure in mid-2006, to a bit more than 3.5% by the end of 2007. These numbers are still small relative to the total stock of mortgages outstanding, but the increase is one worthy of our attention.

We also know that the rapid housing appreciation that occurred in 2005 and 2006 is now a thing of the past (see chart 3). House values are falling in many communities and this is a different picture than the one that prevailed even one year back.

We believe that the decline in housing prices is not primarily a result of foreclosures. The timing does not fit and the causation actually seems to go the other way. Housing starts peaked in January 2006 at almost 2.3 million units at annual rate, and the inventory-to-sales ratio began to rise in late 2005. Downward pressure on prices and reduced liquidity in the market made it more difficult for people to sell or refinance their houses, and some of this showed up in foreclosure rates. I believe that the excessive rate of growth in the stock of housing that occurred a few years ago was the primary cause of downward pressure on housing that we are seeing today.

Chart 2

Percent of Mortgages 90+ Days Past Due or in the Process of Foreclosure

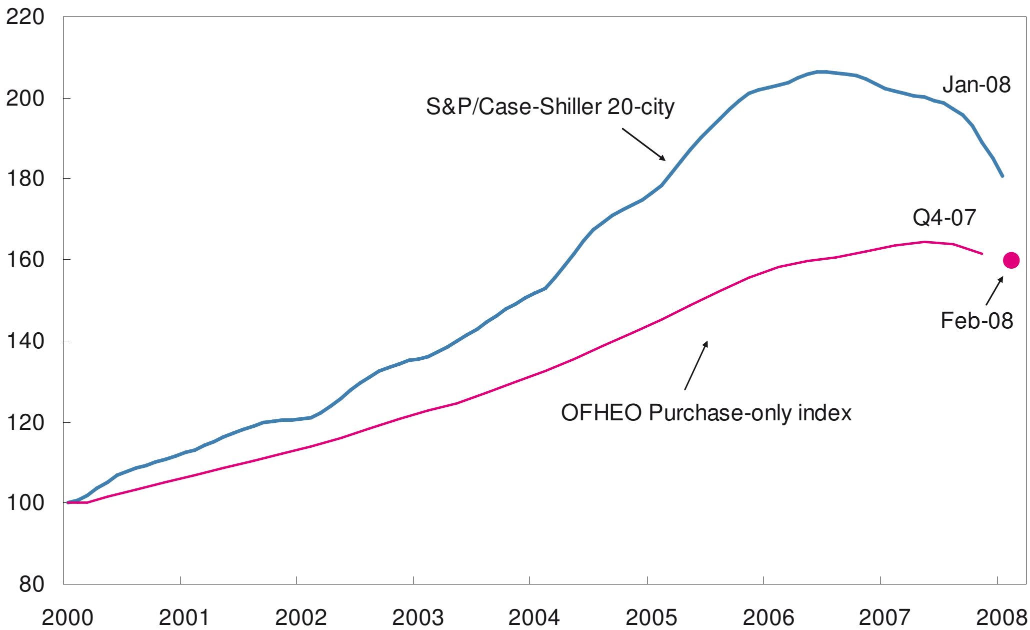


Source: Mortgage Bankers Association.

Chart 3

Home Price Indexes

Index, Q1-2000=100

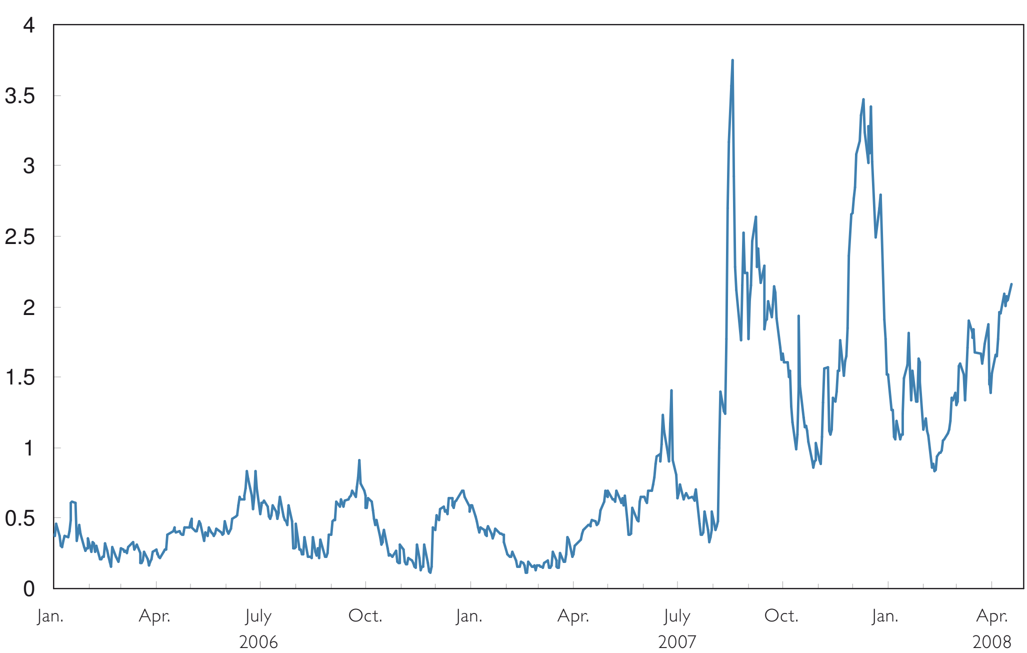


Source: Mortgage Bankers Association.

Chart 4

30-Day Asset Backed Commercial Paper to 1-Month Treasury Bill Spread

Percentage points



Source: Bloomberg LP, Federal Reserve Board.

A primary factor that does have the potential to hurt the economy is credit tightening, which grabbed the world's attention starting last summer. Again the causes are not clear and will be argued for years to come, but the initial picture seems to be one of under-pricing of risk. The under-pricing showed up first in mortgage markets as they related to sub-prime lending, but other financial instruments were affected. As shown in chart 4, the commercial paper spread over Treasuries widened noticeably (and so did corporate spreads). Credit spreads were very low by historic standards and the market seems to be readjusting to data that suggested that risk was under priced.

The credit issues have clearly affected the financial sector. Write-downs at major banks jumped in the latter half of 2007. Our tally of write-downs announced at nine major banks exceeds USD 100 billion between June of last year and the end of the first quarter of this year. A Bloomberg report released a couple of days ago puts total asset write-downs and credit losses since the beginning of 2007 for more than 70 of the world's largest banks and securities firms at nearly USD 290 billion, and some analysts have suggested that they expect write-downs to go much higher. But write-downs per se, while painful, are second to solvency. Most important is that financial institutions continue to have the ability to attract capital. So far, so good on that score.

Other evidence suggests that the financial sector is in decline. Payroll employment in finance, insurance, and real estate fell by 79,000 jobs between July and December and edged down further so far this year.

The effect of credit tightening has shown up dramatically in merger and acquisition activity. For example, a 3-month moving average of announced deals in North America fell from about USD 190 billion in August to under USD 42 billion in November. It seems clear that the difficulties that firms are facing in terms of finding financing for M&A deals is showing up in volume. Additionally, the Federal Reserve's Senior Loan Officer Opinion Survey has shown that banks have been tightening lending standards in recent quarters.

This may not be bad. Lending standards were lowered significantly before the market recognized some of the mistakes of its ways. The proportion of mortgages that are 60 or more days delinquent within the first 5 months of the loan date almost tripled for loans issued late in 2006 and early 2007 as compared with loans made in the first quarter of 2005. The point is that brand new loans at the end of 2006 and early 2007 were much riskier than brand new loans in 2005. Lending standards seem to have relaxed significantly during that period. This is not a reset issue, since these delinquencies are occurring right at the outset. Instead, it reflects loans made under different standards during the past couple of years than were made earlier on. The tightening of lending standards that we now see seems to be at least in part a reaction to this excessive willingness to lend that characterized the period between 2004 and 2006.

Liquidity is a major issue for credit markets around the world. The most obvious manifestation of liquidity difficulties was the Bear Stearns near-bankruptcy that was prevented only by quick action by the Federal Reserve Bank in conjunction with JP Morgan. Since then, credit markets have quieted down somewhat and financial institutions have shown the continued ability to raise money, but we remain vigilant in our monitoring of the credit situation.

What has been the effect of credit tightening on the rest of the economy? Most of our information suggests that through the end of 2007, credit tightening had not affected the ability of firms to invest – at least outside the financial and housing sectors. And even in the first quarter of 2008, the effects have been small, so that in March only 2% of small business owners listed the ability to obtain credit as their number one business problem – a figure that has been roughly steady over the past year. A few warning signs have appeared on the horizon, however, indicating potential additional credit problems. For example, senior loan officers report raising standards on commercial and industrial loans in January. And yields on junk bonds have increased more than a percentage point since year end.

Credit tightness has the potential to affect in a dramatic way business investment, and it is one of the key areas that we monitor. The President's Working Group, which includes the Principals from the Federal Reserve System, Treasury, Securities and Exchange Commission, and the Commodity Futures Trading Commission (CFTC), as well as myself and a number of other White House representatives, meets regularly to discuss long-term reform. These include examination of credit-rating agencies, initiatives involving private pools of capital, the safety and soundness of hedge funds, international accounting standards, the securitization process, risk management, and capital adequacy in banks.

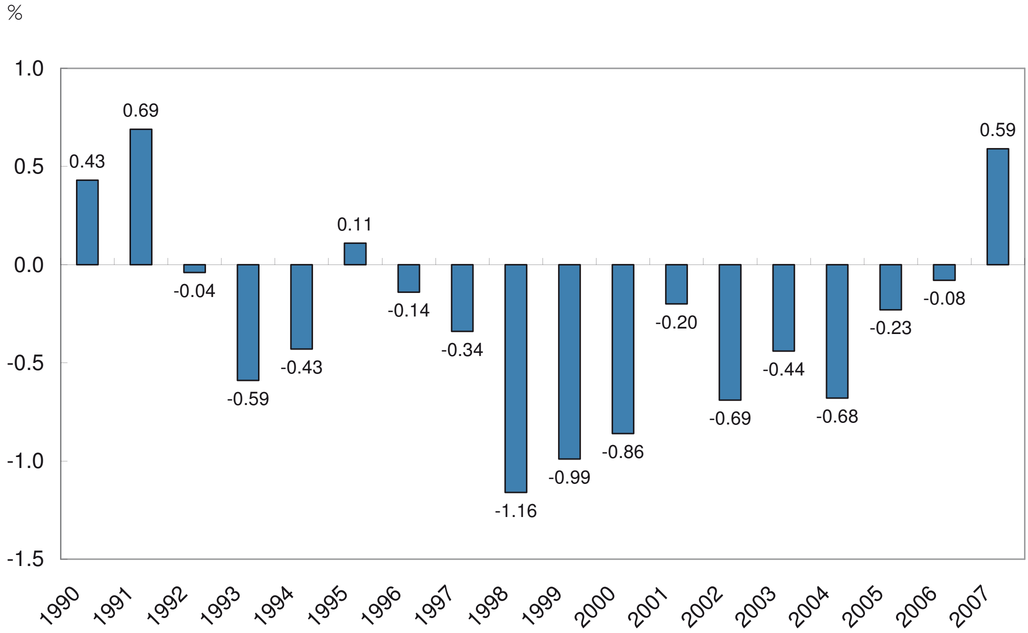
A positive force on growth in the United States is economic activity in the rest of the world. World economic growth in 2007 was strong. And although most forecasts for growth have been lowered for this year, there is still a significant expansion abroad. For example, the International Monetary Fund projects growth around 7% for the emerging economies, but only 1.3% for the advanced economies. A growing world economy is important to the United States for a variety of reasons, the most direct of which is that there is a close link between the change in our trading partners' GDP and changes in demand for American products. To a first approximation, a 1% increase in growth in a trading partner's economy translates into a 1% increase in demand for products from the United States.

Exports have contributed increasingly to U.S. economic growth. Chart 5 shows that since 1990, real net exports have generally subtracted from U.S. GDP growth, but that situation reversed in 2007 with net exports contributing about a half a percentage point to real GDP growth in that year.

It is important to keep this going. The President has emphasized the significance of pending bilateral free trade agreements in a variety of contexts. In addition we continue to press forward to get a good agreement in the Doha Round of the World Trade talks.

Chart 5

Net Export Contributions to U.S. GDP Growth



Source: Commerce Department, Bureau of Economic Analysis.

"Decoupling"

Given that the United States are going through a period of flat economic performance, it is important to ask whether the world has "decoupled" from the U.S.A. It used to be said that when the U.S.A. sneezes, the rest of the world catches cold. Is that less true today than it was a decade or two ago?

For the United States to have an important influence on the rest of the world, two conditions must hold. First, the United States must be a major part of the world economy. Second, the United States must be interconnected with other countries through trade. If the U.S.A. were only 1% of the world economy, it could exert little influence on other larger economies, even if a large share of its products were exported to and goods consumed imported from the rest of the world. Conversely, even if the United States comprised half of world output, it would have little or no effect on other countries if it were closed to imports and exports.

Thus, decoupling is most likely to occur if two conditions hold: First, the United States' share of world GDP has declined over time. Second, the importance of trade with the rest of the world has declined over time. Neither condition appears to have been met.

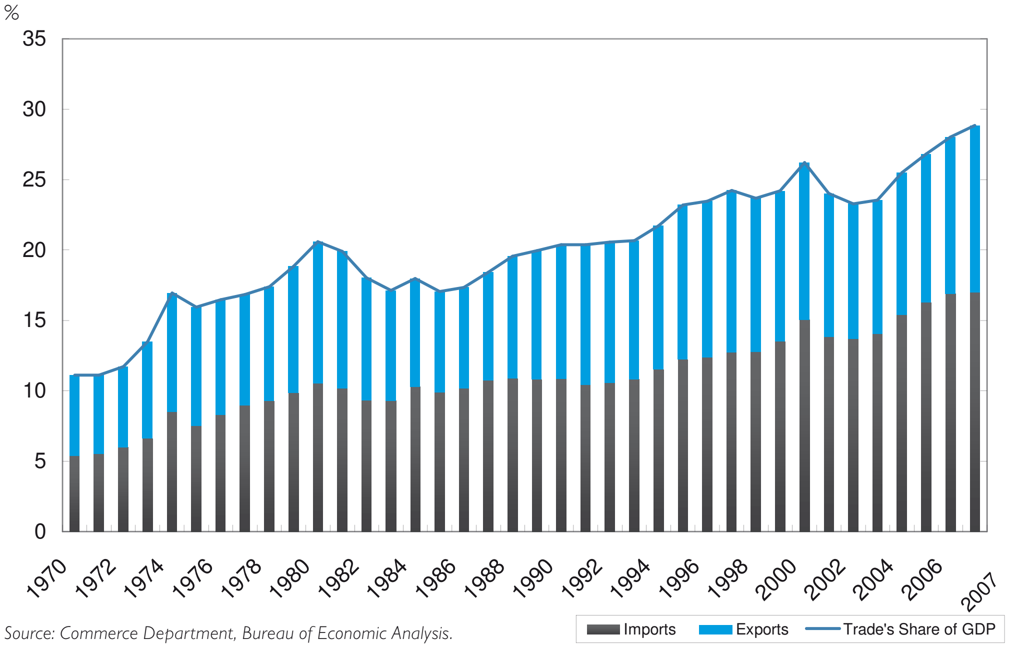
In 1980, the United States accounted for nearly 25% of world GDP. In 2007, the United States accounted for about 27% of world GDP.

Second, the U.S.A. are now more, not less, connected to the rest of the world through trade. Along with world growth has come increased specialization and the division of labor. As a result of falling transport costs, improved technology, trade agreements, and economic development, production has become more refined, and trade has increased.

In 1970, the United States exports plus imports as a share of U.S. GDP

Chart 6

U.S. Trade as a Share of GDP: 1970–2007



Source: Commerce Department, Bureau of Economic Analysis.

were about 11%. As seen in chart 6, the share increased to nearly 29% by the end of 2007. Over the last ten years, the total value of U.S.-EU (EU-15) merchandise trade has nearly doubled (up 88%). And trade between the United States and our host country, Austria, has increased by more than 200%.

If anything, the world is likely to be more integrated rather than more decoupled. We believe these trade linkages help foster growth and increase standards of living in the United States and in the rest of the world. It would be difficult to dispute that China's and India's rising incomes and growing middle classes were not a result of increased interaction with Europe and the United States, as well as the rest of Asia.

Although integration and trade are good for the world economies, increased interdependence also means that the ills of one country may spread to others. Indeed, some of the financial concerns that stem from American institutions and credit market practices have been felt as heavily by some European financial institutions as their American counterparts. We believe that international cooperation, openness and transparency are the best ways to prevent country-specific problems from becoming major faults in the world economy.

The Near Future

Going forward, the President's economic growth package should help stimulate growth. The stimulus package was designed with a particular logic, namely, that there are two major parts of the economy that should be considered: consumption and investment. On the investment side, favorable tax treatment of business investments made in 2008 will create incentives to invest. Because of the temporary nature of the program, businesses need to take advantage of the program this year, which tends to move investment forward into a period during which the economy might experience weak investment growth. Furthermore, we believe that any displacement of investment forward into 2008 will not harm the economy in future years. Those reductions will be smoothed over long periods of time and will likely hit when the economy does not have significant vulnerability.

On the consumption side, reducing taxes always provides some positive effects, and we believe that the adverse consequences to the public debt are minimal. At this point, giving Americans back their money to spend as they see fit will be good for the economy. The approximately USD 100 billion that will go directly into the hands of consumers will allow them to increase consumption, pay down bills, or get a head start on major purchases. All of these activities have positive effects on the economy. Nor is this a hand-out. Most of this – about 65% – takes the form of a tax cut, and even the part that is scored as a payment to individuals that is not strictly a tax reduction has some positive effects on labor supply.

Furthermore, combining business investment incentives with personal tax cuts provides better timing of the growth incentives. The business investment incentives tend to bite as the time period is running out, mainly in the fourth quarter of this year, while the consumption effects may be felt almost immediately as consumers anticipate checks coming in.

It is always difficult to be precise about the estimated effects. Despite that, our best estimates suggest that as a result of the growth package, more than half a million more Americans will be working than would otherwise have been the case. This means that the unemployment rate will be 3 to 4 tenths of a percentage point lower as a result of the stimulus package by the fourth quarter of this year. Businesses can anticipate this increased demand and can act on it.

We are not alone in believing that these effects are considerable. By the third quarter of this year, the Consensus forecast projects solid growth.

The American economy is resilient and has withstood a variety of shocks over the past few years, any one of which might have been expected to cause considerable distress. We started this century with a recession, were soon hit by terrorist attacks that stifled a number of industries. We were blasted by major hurricanes that wiped out a large amount of the physical plant and housing stock in some of our southern states. Despite these difficulties and others, we have maintained a strong economy and low unemployment. We believe that good policies have been part of the reason for sustained growth and a record period of increasing job growth. These days are tough ones for the U.S. economy, but we have seen similar days in the recent past and our economy has rebounded each time. I assure you that the slow growth that we are experiencing right now is a temporary phenomenon. The United States is still a good bet. You can count on us to be a strong and cooperative part of the world economy.

Thank you.