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Moment of Truth for *Global Rebalancing*

November 4, 2011
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Stewardship of the global economy has not exactly been stellar in recent years. Over the past three decades, the world has lurched from crisis to crisis approximately once every three years. From the Latin American Debt Crisis of the early 1980s to the sovereign debt crisis that is now raging in Europe—and with far too many bouts of turmoil in-between—a crisis-prone world has repeatedly compounded its imbalances.

The good news about modern crises is that they always seem to pass. The bad news is that all too often one crisis begets another. At some point in this process, exhaustion is bound to set in. And that's precisely where the world finds itself in the autumn of 2011.

Most of the major advanced economies of the world are now either slowing sharply or are on the cusp of outright recession. That's true of the feeble recovery in the United States, long plagued by subpar job creation and anemic growth in personal consumption. It's also true in crisis-torn Europe, where pan-regional activity has flattened out in the core (Germany and France) but is already declining in in the periphery (Greece, Ireland, Portugal, Spain and Italy). Japan is an exception, where a cyclical rebound now appears to be under way after the devastating Tohoku tsunami and earthquake; however, prior to these devastating natural disasters, the Japanese economy had actually entered its fourth post-bubble recession since the early 1990s.

Nor has the developing world gotten off unscathed. Despite the hopes and dreams of decoupling in a so-called two-speed world, cross border trade and capital flows have made it extremely difficult for anyone to hide. That's especially true of China and India, long the leaders of high-flying Developing Asia, where cyclical slowdowns also appear to be under way.

The net result is a global economy that is now flirting with another recession. The IMF has cut its estimate of 2011 world GDP growth for the second time in three months—this time from 4.3% to 4.0% (and to 3.6% on a fourth quarter to fourth quarter basis). Yes, that's still a considerable distance from the unofficial 2.5% global growth recession threshold, but the risk of further cuts is high and rising.

While the cross-border linkages of globalization speak to an increasingly integrated world economy, there is no single fix that applies uniformly across the major economies. At the same time, the tensions of ever-mounting global imbalances underscore a web of connectivity that links problems across markets and economies. The rebalancing imperatives of an increasingly crisis-prone world must be crafted with those key considerations in mind.

The global economy is now flirting with another recession. A downturn in the developed world will impair growth in export-led developing economies.

The long festering imbalances of the U.S. economy are perhaps the single most important case in point. As productivity, employment, and real wages came under pressure in the 1970s and 1980s, America found new hope in the miracles of financial engineering—namely, the ability to extract purchasing power from assets such as equities and homes.

Yet the new and exciting Asset Economy gave rise to global imbalances of epic proportions. Convinced that it could live well beyond its traditional means, America squandered its income-based saving. By the middle of the 2000s, the personal saving rate had fallen to just 1%, whereas the economy-wide net national saving rate (depreciation-adjusted saving of households, businesses, and the government sector, combined) dipped into negative territory for the first time in modern history.

Note: This article was published in Japan's *Mainichi Economist* on October 31, 2011.

Lacking in saving and more than willing to exploit its position as the world's major reserve currency, asset-dependent, and saving-short America imported surplus saving from abroad in order to grow. And it ran massive current-account and trade deficits in order to attract the foreign capital. As is the case in all games of musical chairs, there were no problems until the music stopped. Only when that occurred in late 2008, was it painfully evident that the siren song of financial engineering had spawned a political economy of false prosperity—built on the quicksand of asset and credit bubbles.

Like Japan of the 1990s, the United States went into a wrenching post-bubble balance sheet recession. Unlike Japan, where zombie-like banks and corporations felt the brunt of the shakeout, in the United States the burden has fallen on over-extended consumers—families who fundamentally altered their lifestyles by mistakenly believing in the miracles of a "costless" equity extraction from asset bubbles.

Sadly, American consumers now finally get it. In the 15 quarters since the first quarter of 2008, annualized growth in inflation-adjusted U.S. consumption expenditures has averaged just 0.4%. Never before has the American consumer—the biggest consumer in the world and more than 70% of the US economy—been this weak for this long. Like the zombies of post-bubble Japan, America's zombie consumers are struggling to regain their economic footing after years of unbridled excess.

The United States hardly had a monopoly on imbalances. As soon as its asset-induced saving shortfall turned into a massive current account deficit, the rest of the world was brought into the equation. Lacking in domestic demand, surplus savers such as China, Japan, and Germany were more than happy to enjoy the benefits of export-led growth directed at over-extended American consumers.

At work are long-simmering global imbalances, which went from 1% of world GDP in the mid-1990s to an unprecedented 6% by 2006.

One country's deficit is a breeding ground for the surpluses of others. As a result, the sum of the world's current account imbalances—deficits and surpluses, combined, irrespective of signs—reached close to 6% of world GDP in 2006—literally six time the magnitude of the 1% reading recorded a decade earlier. On the eve of the Great Crisis, an unbalanced world had upped the ante as never before. And now it is left to pick up the pieces. Three considerations must be at the top of a global rebalancing agenda:

The United States needs to focus on its extraordinary shortfall of consumer demand. Japan did not begin to heal from its balance sheet recession until "zombie congestion" was alleviated by the restructuring and recapitalization of its failed banks and corporations. The same will be the case for America's zombie consumers unless they accelerate their repair of crisis-battered balance sheets. Two initiatives would be especially important in that regard: One, debt forgiveness, especially for mortgages, would go a long way in stabilizing home values; it would have to be funded jointly by lenders, the government, and borrowers who would be asked to give up the time-worn shelter of non-recourse loans. Two, saving incentives would be key in restoring a long-term sense of financial security; they should include expanded IRA and 401K plans, targeted retirement initiatives to low- and middle-income workers, tax reform tilted toward consumption taxes, and a normalization of interest rates by the Fed to end the financial repression of U.S. savers. Washington must also embrace a new policy mandate of financial stability that would prevent ideologically inspired central bankers and fiscal authorities from trying to concoct yet another strain of bubble-induced false prosperity.

The global rebalancing policy agenda must focus on three goals—balance sheet repair of American consumers, fiscal integration in Europe, and pro-consumption structural change in China.

Europe's structural imbalances are playing out right before our eyes. From the start, the EMU never satisfied the basic requirements of the so-called optimal currency zone. It was balanced precariously on only two legs of the stool—a single currency and a new central bank—but was missing the fiscal leg. For a decade, Europe deluded itself—and the world—into thinking it could finesse the missing fiscal piece. All it took was the inevitable asymmetrical shock—the Great Crisis of 2008-09—to unmask this unbalanced strain of false prosperity. Europe now has two choices—a credible pan-regional fiscal structure or a break-up. It's hard to kick a can down a road that has a dead end.

China also faces a daunting rebalancing challenge. Its 30-year growth miracle has left the Chinese economy with major structural imbalances that must now be urgently addressed. The reason: Its all-powerful export machine is facing a new and important challenge. With post-crisis aftershocks likely to hobble Europe and the United States for years to come, export-led Chinese growth is now lacking in support from its two largest sources of external demand. For that reason—along with domestic considerations of mounting income inequalities, excess resource consumption, and environmental degradation—China must move quickly to rebalance and implement the pro-consumption policy agenda of its newly enacted 12th Five-Year Plan. Gradualism

and delay are recipes for growth accidents and social instability that modern China must avoid.

One can only hope that the turmoil and chaos of the past three years is a wake-up call for a crisis-prone world to finally get on with the heavy lifting of global rebalancing. Every era of excess has its cheerleaders and denialists who offer the seductive proposition of a new paradigm of prosperity. But with the developed world now staring into yet another abyss, it is high time to recognize that unbalanced growth is not a recipe for sustainable growth. The alternative is unthinkable.

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