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A World in Crisis

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Introduction

As the greatest beneficiary of globalization, Asia continues to take an important cue from the broader global environment. With the world economy in its most wrenching crisis in 75 years, that cue is more daunting than ever before.

The origins of this crisis will long be debated. As the world still grapples with the wrenching aftershocks of what was initially billed as America's subprime crisis, it is entirely premature to render a definitive verdict on the how's and why's of this mess. Suffice it say, the financial crisis that began in earnest in 2008 was the outgrowth of a confluence

of failures, including massive risk management mistakes on Wall Street, egregious errors by rating agencies, staggering lapses of regulatory oversight, a politicization of the home-ownership and mortgage boom, and the search for returns by yield-hungry investors on Main Street. The most serious failure, in my view, was that of central banks. That's especially the case with America's ideologically driven Federal Reserve, led by market libertarians who condoned an insidious succession of asset bubbles and ignored its regulatory responsibility in an era of unprecedented financial engineering and excess leverage.

The main thesis of this chapter is that this is not just a financial crisis. The excesses in the financial markets were so extreme they ended up infecting the real side of the global economy. Nowhere was that more evident than in the United States, where asset-dependent consumers drew extraordinary support from the confluence of property and credit bubbles. In the second half of 2008—in the aftermath of the bursting of those twin bubbles—the American consumer pulled back more severely than at any point in the post-World War II era. Yet that correction left the consumption share of GDP at a still elevated 71 percent in late 2008—down only 1 percentage point from its record 72 percent high in early 2007 and 4 percentage points above the prebubble norm of 67 percent that prevailed from 1975–2000. With personal debt ratios still excessive and saving rates far too low, there is good reason to believe that there is more to come in what looks to be a multiyear adjustment for the U.S. consumer. If mean reversion is in the offing for a postbubble U.S. consumer, and if that mean is close to the prebubble norm of the consumption share of U.S. GDP, then only about 20 percent of the correction has occurred.

As America has entered a major postbubble shakeout, so, too, has the rest of an interconnected world. It's not just the cross-border linkages of trade flows that have been shocked by the capitulation of the world's largest consumer. Liquidity-driven asset bubbles have burst everywhere—from emerging market equities to most segments of the global commodity market. The pitfalls of a postbubble world are especially daunting for an externally led Asian economy.

Lacking dynamism from its main source of external demand—the U.S. consumer—Asia faces two distinct possibilities: slower growth or the imperatives of uncovering new sources of growth. Since the latter option takes time to implement, I conclude that the Asian growth dynamic is likely to be a good deal slower in the years ahead than the

7 percent growth pace that has been realized since the turn of the century. For now, I would pencil in about 5 percent growth in panregional GDP for Developing Asia over the next three to five years.

A similar downshift is likely to be in the offing for the global economy. Notwithstanding the massive policy stimulus that has been injected into the system, America's multiyear consumer retrenchment will provide stiff headwinds to global growth for quite some time. In that important respect, policy stimulus will be "pushing on a string"—leading to something resembling a Japanese-like outcome for a postbubble world economy. There will be no V-shaped recovery from this global recession. When it comes in earnest—probably at some point in 2010—the rebound in world economic growth is likely to be unusually anemic.

Meanwhile, it's important not to get too far ahead of this story—a postcrisis world still has to pick up the pieces from a wrenching global recession. This is a profound challenge to policy makers, regulators, and politicians—to say nothing of posing a challenge to the free-enterprise system of market capitalism. To date, the policy response has been very short-term oriented. In effect, it has marshaled the heavy artillery of fiscal and monetary policy, together with government-sponsored capital injections and bailouts, toward rescuing and restarting a damaged and dysfunctional financial system.

Although this short-term focus is understandable in light of the extraordinarily dangerous freezing up of global credit markets, there are deeper longer-term issues that policy makers must also confront. At the top of the list are the daunting imperatives for a postbubble world to come up with nothing short of a new recipe for economic growth. In effect, the unbalanced global growth model of the past decade—dominated by America's excess consumption and Asia's excess saving—needs to be turned inside out. The United States needs to save more and consume less while Asia needs to save less and consume more. Policies need to be directed toward those twin objectives with an aim toward fostering the long-awaited rebalancing of a postbubble world. The crisis that began in 2008 is a wake-up call that global rebalancing can no longer be deferred to that proverbial another day.

The problem is not with capitalism but with its system of governance. As such, this crisis is a wake-up call to central banks, regulators, and their political overseers—the authorities who are charged with being the ultimate whistle-blowers in an era of excess. Sadly, that didn't happen as a bubble-prone world lurched headlong toward

disaster. Central banks were especially derelict in their responsibilities. Although the monetary authorities did a terrific job in winning the war against the Great Inflation of the 1970s and early 1980s, they failed in their efforts to manage the peace of the postinflation global economy. Blinded by ideology, monetary policy makers paid little or no attention to the imperatives of financial stability. Instead, they believed incorrectly that the world was learning to live with its imbalances. Needless to say, the postbubble world is paying a horrific price for this dereliction of duty. That leaves the body politic with little choice other than to alter the policy mandate of central banks to incorporate an explicit focus on financial stability. A crisis like this must never be allowed to happen again.

A Subprime Outlook for the Global Economy

October 18, 2007

After nearly five fat years, the global economy is headed for serious trouble. This will come as a surprise to policy makers and investors, alike—most of whom were counting on boom times to continue.

At work is yet another postbubble adjustment in the world's largest economy—this time, the bursting of America's massive property bubble. The subprime fiasco is the tip of a much larger iceberg—an asset-dependent American consumer who has gone on the biggest spending binge in the modern history of the global economy. At the turn of the century, the bursting of the dot-com bubble triggered a collapse in business capital spending that took the United States and global economy into a mild recession. This time, postbubble adjustments seem likely to hit U.S. consumption, which, at 72 percent of GDP, is more than five times the share the capital spending sector was seven years ago. This is a much bigger problem—one that could have much graver consequences for the United States and the rest of the world.

There is far more to this story than a potential downturn in the global business cycle. Another postbubble shakeout poses a serious challenge to the timeworn inflation-targeting approach of central banks. It also challenges the body politic's acceptance of a new strain of asset-dependent global economic growth. Subprime spillovers have only just begun to play out, as has the debate this crisis has spawned.

Game Over for the American Consumer

The American consumer has been the dominant engine on the demand side of the global economy for the past 11 years. With real consumption

growth averaging nearly 4 percent over the 1996–2006 interval, U.S. consumption expenditures totaled over \$9.6 trillion in 2007, or 19 percent of world GDP (at market exchange rates).

Growth in U.S. consumer demand is typically powered by two forces— income and wealth (see Figure 1.1). Since the mid-1990s, income support has lagged while wealth effects have emerged as increasingly powerful drivers of U.S. consumption. That has been especially the case in the current

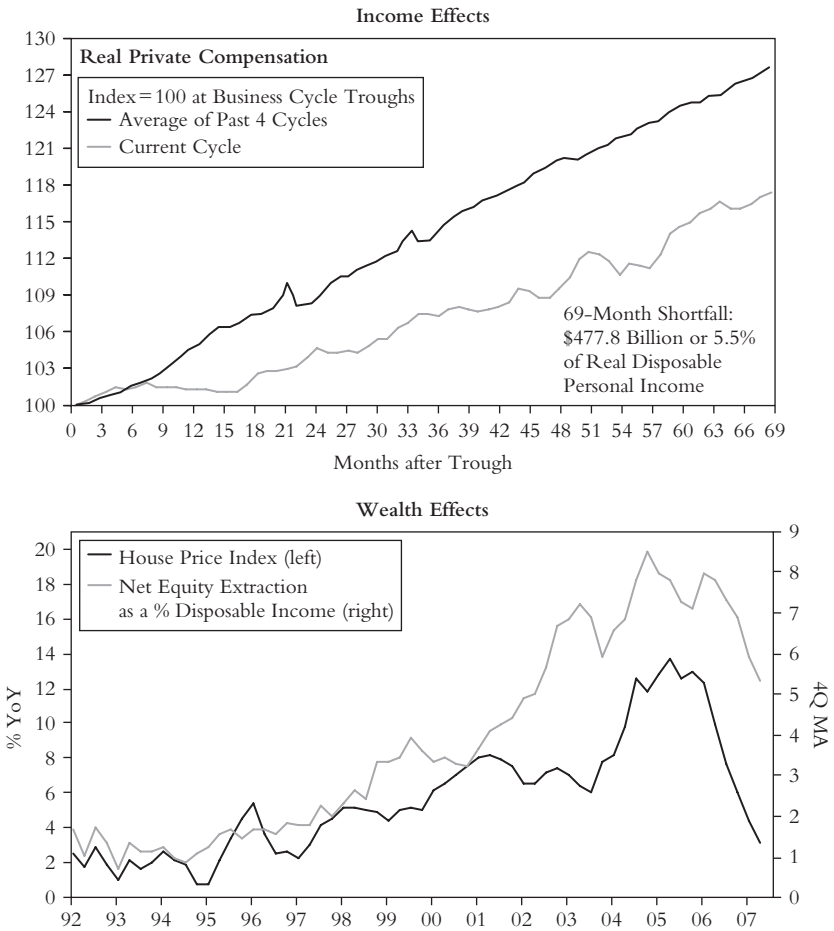


Figure 1.1 The Macro Drivers of U.S. Consumption

Source: Office of Federal Housing Enterprise Oversight (OFHEO), Federal Reserve, U.S. Bureau of Economic Analysis, Morgan Stanley Research.

economic expansion, which has faced the combined headwinds of subpar employment growth and relatively stagnant real wages. As a result, over the first 69 months of the now-ended expansion, private-sector compensation—the broadest measure of earned labor income in the U.S. economy—increased only 17 percent in real, or inflation-adjusted, terms. That was nearly \$480 billion short of the 28-percent increase that had occurred, on average, over comparable periods of the past four U.S. business cycle expansions.

Lacking in support from labor income, U.S. consumers turned to wealth effects from rapidly appreciating assets—principally residential property—to fuel booming consumption. By Federal Reserve estimates, net equity extraction from residential property surged from 3 percent of disposable personal income in 2001 to nearly 9 percent by 2005—more than sufficient to offset the shortfall in labor income generation and keep consumption on a rapid growth path. There was no stopping the asset-dependent American consumer.

That was then. Both income and wealth effects have come under increasingly intense pressure—leaving consumers with little choice other than to rein in excessive demand. The persistently subpar trend in labor income growth is about to be squeezed further by the pressures of a cyclical adjustment in production and employment. In August and September 2007, private sector nonfarm payrolls expanded, on average, by only 52,000 per month—literally one-third the average pace of 157,000 of the preceding 24 months. Moreover, this dramatic slowdown in the organic job-creating capacity of the U.S. economy is likely to be exacerbated by a sharp fall in residential-construction-sector employment in the months ahead. Jobs in the homebuilding sector are currently down only about 5 percent from peak levels, despite a 40 percent fall in housing starts; it is only a matter of time before jobs and activity move into closer alignment in this highly cyclical—and now very depressed—sector.

Moreover, the bursting of the property bubble has left the consumer wealth effect in tatters. After peaking at 13.6 percent in mid-2005, nationwide house price appreciation slowed precipitously to 3.2 percent by mid-2007. Given the outsize overhang of excess supply of unsold homes, I suspect that overall U.S. home prices could actually decline in both 2008 and 2009—an unprecedented development in the modern-day experience of the U.S. economy. Mirroring this trend, net equity extraction has already tumbled—falling to less than 5.5 percent of disposable personal income in the second quarter of 2007 and retracing more than

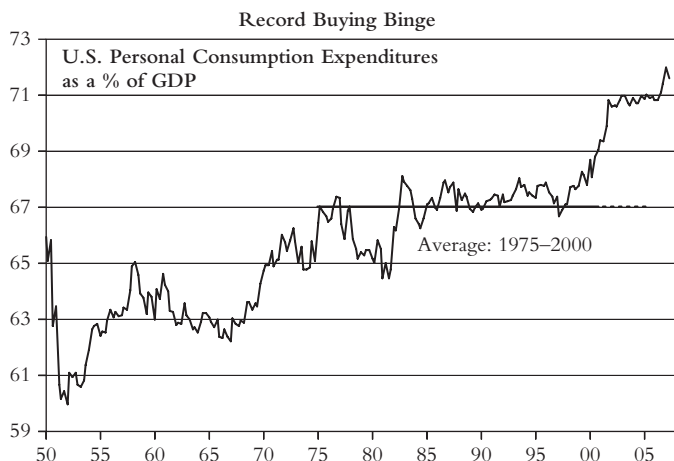


Figure 1.2 The Overextended American Consumer

Source: U.S. Bureau of Economic Analysis, Morgan Stanley Research.

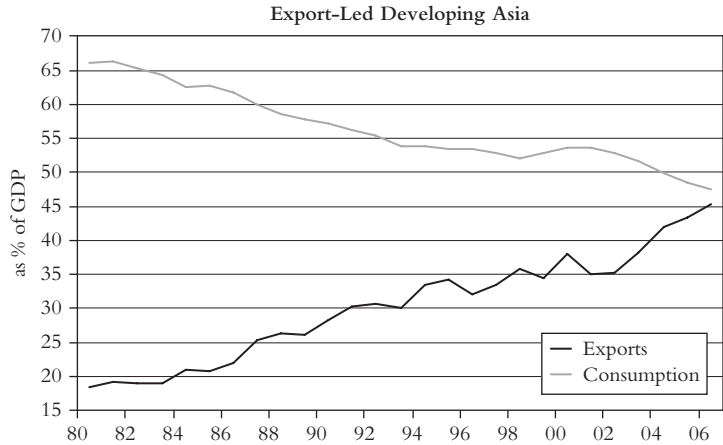
half the run-up that began in 2001. Subprime contagion can only reinforce this trend—putting pressure on home mortgage refinancing and thereby further inhibiting equity extraction by U.S. home owners.

With both income and wealth effects under pressure, it will be exceedingly difficult for savings-short, overly indebted American consumers to maintain excessive consumption growth. For a U.S. economy that has drawn disproportionate support from a record 72 percent share of personal consumption (see Figure 1.2), a consumer-led capitulation spells high and rising recession risk. Unfortunately, the same prognosis is likely for a still U.S.-centric global economy.

Don't Count on Global Decoupling

A capitulation of the American consumer spells considerable difficulty for the global economy. This conclusion is, of course, very much at odds with the notion of “global decoupling”—an increasingly popular belief that depicts a world economy that has finally weaned itself from the ups and downs of the U.S. economy.

The global decoupling thesis is premised on a major contradiction: In an increasingly globalized world, cross-border linkages have become ever more important—making globalization and decoupling inherently



| Export Linkages to the United States | | |
|--------------------------------------|---------------------|-----------------------|
| | Export Share of GDP | U.S. Share of Exports |
| China | 36.6 | 21.0 |
| Japan | 14.8 | 22.5 |
| Korea | 36.7 | 13.3 |
| Taiwan | 59.0 | 14.4 |
| ASEAN | 72.7 | 13.6 |

Figure 1.3 The Myth of an Asian Decoupling
Source: International Monetary Fund, Asian Development Bank, Morgan Stanley Research.

inconsistent. True, the recent data flow raises some questions about this contention. After all, the world seems to have held up reasonably well in the face of the initial slowing of U.S. GDP growth that has unfolded over the past year. However, that’s because the downshift in U.S. growth has been almost exclusively concentrated in residential building activity—one of the least global sectors of the U.S. economy. If I am right, and consumption now starts to slow, such a downshift will affect one of the most global sectors of the United States. I fully suspect a downshift in America’s most global sector will have considerably greater repercussions for the world at large than has been the case so far.

That’s an especially likely outcome in Asia—the world’s most rapidly growing region and one widely suspected to be a leading candidate for global decoupling. However, as Figure 1.3 clearly indicates, the macrostructure of Developing Asia remains very much skewed toward an export-led

growth dynamic. For the region as a whole, the export share has more than doubled over the past 25 years—surging from less than 20 percent in 1980 to more than 45 percent today. Similarly, the share going to internal private consumption—the sector that would have to drive Asian decoupling—has fallen from 67 percent to less than 50 percent over the same period.

Nor can there be any mistake about the dominant external market for export-led Asian economies. The United States wins the race hands down—underscored by a 21 percent share of Chinese exports currently going to America. Yes, there has been a sharp acceleration of intraregional trade in recent years, adding to the hopes and dreams of Asian decoupling. But a good portion of that integration reflects the development of a China-centric pan-Asian supply chain that continues to be focused on sourcing end-market demand for American consumers. That means if the U.S. consumer now slows, as I suspect, Asia will be hit hard—with cross-border supply-chain linkages exposing a long-standing vulnerability that will draw the global decoupling thesis into serious question.

A downshift of U.S. consumption growth will affect Asia unevenly. A rapidly growing Chinese economy has an ample cushion to withstand such a blow. Chinese GDP growth might slow from 11 percent to around 8 percent—hardly a disaster for any economy and actually consistent with what Beijing has tried to accomplish with its cooling-off campaign of the past several years. Other Asian economies, however, lack the hyper-growth cushion that China enjoys. As such, a U.S.-led slowdown of external demand could hurt them a good deal more. That's especially the case for Japan, whose 2 percent growth economy could be in serious trouble in the event of a U.S.-demand shock that also takes a toll on Japanese exports into the Chinese supply chain. Although less vulnerable than Japan, Taiwan and South Korea could also be squeezed by the double whammy of U.S. and China slowdowns. For the rest of Asia—especially India and the ASEAN economies—underlying growth appears strong enough to withstand a shortfall in U.S. consumer demand. But there can be no mistaking the end-game: Contrary to the widespread optimism of investors and policy makers, the Asian growth dynamic is actually quite vulnerable to a meaningful slowdown in U.S. consumption growth.

The Great Failure of Central Banking

The recent chain of events is not an isolated development. In fact, for the second time in seven years, the bursting of a major asset bubble has

inflicted great damage on world financial markets. In both cases—the equity bubble in 2000 and the credit bubble in 2007—central banks were asleep at the switch. The lack of monetary discipline has become a hallmark of an unfettered globalization. Central banks have failed to provide a stable underpinning to world financial markets and to an increasingly asset-dependent global economy.

This sorry state of affairs can be traced to developments that all started a decade ago. Basking in the warm glow of a successful battle against inflation, central banks decided that easy money was the world's just reward.

America's IT-enabled productivity resurgence in the late 1990s was the siren song for the Greenspan-led Federal Reserve—convincing the U.S. central bank that it need not stand in the way of either rapid economic growth or excess liquidity creation. In retrospect, that was the “original sin” of bubble-world—a Fed that condoned the equity bubble of the late 1990s and the asset-dependent U.S. economy it spawned. That set in motion a chain of events that has allowed one bubble to beget another—from equities to housing to credit—as the Fed countered each postbubble aftershock by an aggressive monetary easing that set the stage for the next bubble.

There is one basic problem with all asset bubbles—they always burst. And when that happened to the equity bubble in 2000, the Federal Reserve threw all caution to the wind and injected massive liquidity into world financial markets in order to avoid a dangerous deflation. With globalization restraining inflation and real economies recovering only sluggishly in the early 2000s, that excess liquidity went directly into asset markets.

Aided and abetted by the explosion of new financial instruments—especially what is now over \$440 trillion of derivatives worldwide—the world embraced a new culture of debt and leverage. Yield-hungry investors, fixated on the retirement imperatives of aging households, acted as if they had nothing to fear. Risk was not a concern in an era of open-ended monetary accommodation cushioned by what was mistakenly believed to be a profusion of derivatives-based shock absorbers.

As always, the cycle of risk and greed went to excess. Just as dot-com was the canary in the coalmine seven years ago, subprime was the warning shot this time. Denial in both cases has eerie similarities—as do the spillovers that inevitably occur when major asset bubbles pop. When the dot-com bubble burst in early 2000, the optimists said not to worry—after all, Internet stocks

accounted for only about 6 percent of total U.S. equity market capitalization at the end of 1999. Unfortunately, the broad S&P 500 index tumbled some 49 percent over the ensuing two-and-a-half years, and an overextended Corporate America led the U.S. and global economy into recession.

Similarly, today's optimists are preaching the same gospel: Why worry, they say, if subprime is only about 14 percent of total U.S. securitized mortgage debt? Yet the unwinding of the far-broader credit cycle, to say nothing of the extraordinary freezing up of key short-term financing markets, gives good reason to worry—especially for overextended American consumers and a still U.S.-centric global economy.

Central banks have now been forced into making emergency liquidity injections. The jury is out about whether these efforts will succeed in stemming the current rout in still overvalued credit markets. Although tactically expedient, these actions may be strategically flawed because they fail to address the moral hazard dilemma that continues to underpin asset-dependent economies. Is this any way to run a modern-day world economy?

The answer is an unequivocal “no.” As always, politicians are quick to grandstand and blame financial fiduciaries for problems afflicting uneducated, unqualified borrowers. Yet the markets are being painfully effective in punishing these parties. Instead, the body politic needs to take a look in the mirror—especially at the behavior of its policy-making proxies and regulators, the world's major central banks.

It is high time for monetary authorities to adopt new procedures—namely, taking the state of asset markets into explicit consideration when framing policy options. Like it or not, we now live in an asset-dependent world. As the increasing prevalence of bubbles indicates, a failure to recognize the interplay between the state of asset markets and the real economy is an egregious policy error.

That doesn't mean central banks should target asset markets. It does mean, however, that they need to break their one-dimensional fixation on CPI-based inflation and also pay careful consideration to the extremes of asset values. This is not that difficult a task. When equity markets go to excess and distort asset-dependent economies as they did in the late 1990s, central banks should run tighter monetary policies than a narrow inflation target would dictate. Similarly, when housing markets go to excess, when subprime borrowers join the fray, or when corporate credit becomes freely available at ridiculously low “spreads,” central banks should lean against the wind.

The current financial crisis is a wake-up call for modern-day central banking. The world can't afford to keep lurching from one bubble to another.

The cost of neglect is an ever-mounting systemic risk that could pose a grave threat to an increasingly integrated global economy. It could also spur the imprudent intervention of politicians, undermining the all-important political independence of central banks. The art and science of central banking is in desperate need of a major overhaul.

The Political Economy of Asset Bubbles

There may be a deeper meaning to all this. It is far-fetched to argue that central banks have consciously opted to inflate a series of asset bubbles—and then simply deal with the aftershocks once they burst. At work, instead, are the unintended consequences of a new and powerful asset-led global growth dynamic that is very much an outgrowth of the political economy of growth and prosperity.

This outcome reflects the confluence of three megatrends—globalization, the IT revolution, and the provision of retirement income for aging workers. Globalization has injected a powerful new impetus to the disinflation of the past quarter century, facilitating a cross-border arbitrage of costs and prices that has put unrelenting pressure on the pricing of goods and many services, alike. At the same time, IT-enabled productivity enhancement—initially in the United States but now increasingly evident in other economies—has convinced central banks that there has been a meaningful increase in the noninflationary growth potential in their respective economies. Finally, rapidly aging populations in Japan, Europe, and the United States are putting pressure on plan sponsors—public and private, alike—to boost investment yields in order to fund a growing profusion of unfunded pension and retirement schemes.

A key result of the interplay between the first two of these megatrends—the globalization of disinflation and IT-enabled productivity enhancement—has been a sharp reduction in nominal interest rates on sovereign fixed-income instruments for short- and long-term maturities, alike. Lacking in the yield to fund retirement programs from such riskless assets, investors and their fiduciaries have ventured into increasingly riskier assets to square the circle. That, in conjunction with the ample provision of liquidity from inflation-relaxed central banks, has driven down yield spreads in a variety of risky assets—from emerging-market and high-yield corporate debt to mortgage-backed securities and a host of other complex structured products. In an era of spread compression and search for yield, the rising tide of ample liquidity covered up a profusion of jagged and dangerous rocks. As the tide now goes

out, the rocks now get uncovered. The subprime crisis is a classic example of what can be unmasked at low tide.

The same set of forces has had an equally profound impact on the investment strategies of individual investors. Lacking in traditional yield from saving deposits and government bonds, families have opted, instead, to seek enhanced investment income from equities and, more recently, from residential property. This has created a natural demand for these asset classes that then took on a life of its own—with price increases begetting more price increases and speculative bubbles arising as a result. As long as inflation-targeting central banks remained fixated on their well-behaved narrow CPIs, there was little to stand in the way of a powerful liquidity cycle that gave rise to a multibubble syndrome.

In the end, it is up to the body politic to judge the wisdom of this arrangement—essentially, whether the inherent instability of increasingly asset-dependent and bubble-prone economies is worth the risk. Lacking a clear feedback mechanism to render such a verdict, it falls to the world's central banks—the stewards of economic and financial stability—to act as proxies in resolving this problem. This is where the problem gets particularly thorny. It takes a truly independent central bank to take a principled stand against the systemic risks that may arise from the progrowth mindset of the body politic and act to “take the punchbowl away just when the party is getting good”—to paraphrase the sage advice of one of America's legendary central bankers, William McChesney Martin. Yet as recently retired Fed Chairman Alan Greenspan concedes, “I regret to say that Federal Reserve independence is not set in stone.”¹

Greenspan's confession underscores the important distinction between two models of the central banker—those who are truly politically independent and those who are more politically compliant. The United States has had both types. I would certainly put Paul Volcker in the former category; amid howls of protest, his determined assault against the ravages of double-digit inflation was conducted at great political risk. In the end, he held to a monetary policy that was fiercely independent of political pressures. By contrast, Arthur Burns, who I worked for in the 1970s, was highly politicized in his decisions to avoid the wrenching monetary tightening that a cure for inflation would eventually require. The market-friendly stance of Alan Greenspan—and the asset-dependent

1. See Alan Greenspan, *The Age of Turbulence: Adventures in a New World*, New York: The Penguin Press, 2007.

U.S. economy it spawned—was more consistent with the model of the complaint central banker who was very much in sync with the pro-growth mindset of the body politic. Greenspan's memoirs are as much about politics as economics—underscoring his much stronger sense of the interplay between these two forces than a more independent central banker might otherwise perceive.

However, Greenspan's basic point is well taken: It is not easy for any central banker to do unpopular things—especially if he happens to be a political animal operating in a highly charged political climate. But that's where I would draw the line. With all due respect to Alan Greenspan, the truly independent central banker was never supposed to win political popularity contests. I would be the first to concede, however, that it will take great political courage to forge the new approach toward monetary policy that I am advocating, but it can be done—as exemplified by the legacy of Paul Volcker.

In the end, it will undoubtedly take a crisis to provide central banks with the political cover they believe they need to broaden out their mandate from the narrow dictums of consumer price index (CPI)-based price stability. With the credit cycle unwinding at the same time that Washington might be tempted by protectionism, and with the overly indebted American consumer in trouble, the wisdom of condoning asset-dependent, bubble-prone economies may finally be drawn into serious question.

A Subprime Prognosis

How all this plays out in the global economy in the years immediately ahead is anyone's guess. I have long framed the tensions shaping the outlook in the context of global rebalancing—the need for a lopsided world economy to wean itself from a US.-centric growth dynamic. A partial rebalancing now appears to be at hand—likely to be led by the coming consolidation of the American consumer. That is painful but good news for those of us who have long worried about the destabilizing risks of a massive U.S. current-account deficit. But a more complete global rebalancing is a shared responsibility—one that must also be accompanied by an increase in domestic demand from surplus-saving economies elsewhere in the world. To the extent that doesn't happen—and, as underscored earlier, that remains my view—then an asymmetrical rebalancing dominated by slowdown in U.S. consumer demand should take a meaningful toll on global growth.

For a world economy that has been on a close to 5 percent growth path for nearly five years, that points to nothing but downside over the next few years. It's always hard to pinpoint the magnitude of such a shortfall with any precision, but I would not be surprised to see world GDP growth slow to a virtual standstill at some point in 2008. Such an outcome could prove especially troublesome for the earnings optimism still embedded in global equity markets. The silver lining of such a prognosis likely would be cyclical relief on the inflation front—providing support for sovereign bonds.

But, as I have attempted to underscore earlier, the issues shaping the medium-term prognosis for the global economy go far beyond a standard call on the business cycle. America's asset-dependent growth paradigm is finally at risk. And with those risks comes the potential for collateral damage elsewhere in a still U.S.-centric global economy. Dollar risks are especially problematic but so, too, is the collective wisdom—or lack thereof—of central bankers and politicians who have allowed the world to come to this precarious point. Policy making and politics remain driven purely by local considerations. Yet the stresses and strains of a globalized world demand a much broader perspective. A new approach is needed—before it's too late.



Save the Day

September 25, 2007

Currencies are first and foremost relative prices—in essence, they are measures of the intrinsic value of one economy versus another. On that basis, the world has had no compunction in writing down the value of the United States over the past several years. The dollar, relative to the currencies of most of America's trading partners, had fallen by about 20 percent from its early 2002 peak. Recently it has hit new lows against the euro and a high-flying Canadian currency, likely a harbinger of more weakness to come.

Sadly, none of this is surprising. Because Americans haven't been saving in sufficient amounts, the United States must import surplus savings from abroad in order to grow. And it has to run record balance of payments and trade deficits in order to attract that foreign capital. The United States current account deficit—the broadest gauge of America's imbalance in relation to the rest of the world—hit a record 6.2 percent of GDP in 2006 before the pressures of the business cycle triggered a temporary reduction in 2008. Even so, savings-short America must still attract some \$3 billion of foreign capital each business day in order to keep its economy growing.

Economic science is very clear on the implications of such huge imbalances: Foreign lenders need to be compensated for sending scarce capital to any country with a deficit. The bigger the deficit, the greater the compensation. The currency of the deficit nation usually bears the brunt of that compensation. As long as the United States fails to address its saving problem, its large balance of payments deficit will persist and the dollar will eventually resume its decline.

The only silver lining so far has been that these adjustments to the currency have been orderly—declines in the broad dollar index averaging a little less than 4 percent per year since early 2002. Now, however,

the possibility of a disorderly correction is rising—with potentially grave consequences for the American and global economy.

A key reason is the mounting risk of a recession in America. The bursting of the subprime mortgage bubble—strikingly reminiscent of the dot-com excesses of the 1990s—could well be a tipping point. In both cases, financial markets and policy makers were steeped in denial over the risks. But the lessons of postbubble adjustments are clear. Just ask economically stagnant Japan. And of course, the United States lapsed into its own postbubble recession in 2000 and 2001.

Sadly, the endgame could be considerably more treacherous for the United States than it was seven years ago. In large part, that's because the American consumer is now at risk. In early 2007, consumption expenditures peaked at a record 72 percent of the GDP—a number unmatched in the annals of modern history for any nation.

This buying binge has been increasingly supported by housing and lending bubbles. Yet home prices are now headed lower—probably for years—and the fallout from the subprime crisis has seriously crimped home mortgage refinancing. With weaker employment growth also putting pressure on income, the days of open-ended American consumption are finally coming to an end. This makes it all but impossible to avoid a recession.

Fearful of that outcome, foreign investors are becoming increasingly skittish over buying dollar-based assets. The spillover effects of the subprime crisis into other asset markets—especially mortgage-backed securities and asset-backed commercial paper—underscore these concerns. Foreign appetite for U. S. financial instruments is likely to be sharply reduced for years to come. That would choke off an important avenue of capital inflows, putting more downward pressure on the dollar.

The political winds are also blowing against the dollar. In Washington, China-bashing is the bipartisan sport *du jour*. New legislation is likely, which would impose trade sanctions on China unless China makes a major adjustment in its currency. Not only would this be an egregious policy blunder—attempting to fix a multilateral deficit with nearly 100 nations by forcing an exchange rate adjustment with one country—but it would also amount to Washington taxing one of America's major foreign lenders.

That would undoubtedly reduce China's desire for U. S. assets, and unless another foreign buyer stepped up, the dollar would come under even more pressure. Moreover, the more the Fed under Ben Bernanke

follows the easy-money Alan Greenspan script, the greater the risk to the dollar.

Why worry about a weaker dollar? The United States imported \$2.2 trillion of goods and services in 2006. A sharp drop in the dollar makes those items considerably more expensive—the functional equivalent of a tax hike on consumers. It could also stoke fears of inflation—driving up long-term interest rates and putting more pressure on financial markets and the economy, exacerbating recession risks. Optimists may draw comfort from the vision of an export-led renewal arising from a more competitive dollar. Yet history is clear: No nation has ever devalued its way into prosperity.

So far, the dollar's weakness has not been a big deal. That may now be about to change. Relative to the rest of the world, the United States looks painfully subprime. So does its currency.

Coping with a Different Recession

January 17, 2008

This is not a garden-variety recession. The U.S. economy has slipped into its second postbubble downturn in seven years. Just as the bursting of the dot-com bubble triggered a recession in 2001–2002, the simultaneous popping of housing and credit bubbles are doing the same right now. This recession will be deeper than the shallow contraction earlier in this decade. Back then, the dot-com-led downturn was sparked by a collapse in business capital spending—a sector that at its peak in 2000 accounted for only 13 percent of U.S. GDP. The current recession is all about the coming capitulation of the American consumer—a sector that amounts to a record 72 percent of GDP, or over five times the share of the capital-spending sector that triggered the post-bubble recession seven years ago.

For asset-dependent U.S. consumers, retrenchment is all but inevitable. With income growth lagging, the spending binge of the past six years was reinforced by a surge of housing-led wealth creation. That bonanza is now over. Home prices fell for the nation as a whole in 2008—the first such occurrence since 1933. And that is not exactly a comforting comparison. Moreover, access to home equity credit lines and mortgage refinancing—the means by which home owners have borrowed against their property—has been impaired by the aftershocks of the subprime crisis. As a result, consumers now have to resort to spending and saving the old-fashioned way—drawing the bulk of their support from income rather than assets. In what is likely to be an increasingly sluggish income climate, that spells a meaningful pullback of consumer expenditures. For that reason, alone, it was all but impossible for the United States to avoid outright recession.

Global Implications

This is a very big deal for the broader global economy. Initially, the world has held up relatively well in the face of a prerecession downshift in the U.S. economy. But that quickly changed when America's recession shifted from homebuilding activity—its least global sector—to consumer demand, its most global sector. For the rest of the world, this transition came as a rude awakening. Many have been banking on a “global decoupling”—in essence, resilience elsewhere in the world in the face of a U.S.-demand shock. In particular, there was hope that young consumers from rapidly growing developing economies could fill the void left by weakness in U.S. consumers.

That hope was misplaced. The U.S. consumer is, by far, the biggest consumer in the world. Americans spent over \$9.5 trillion in 2007, whereas the Chinese consumer spent around \$1 trillion and Indians another \$650 billion. Given the huge scale of U.S. consumption, it is almost mathematically impossible for Chinese and Indians to fill the void left by a meaningful pullback of the American consumer. For export-led developing economies in Asia, as well as for Japan, a weakening of U.S. consumption represents a softening in one of their biggest destinations of end-market demand. Lacking in vigor from its internal private consumption, the likelihood of growth slowdowns in externally dependent Asian economies is quite high.

A recent softening of Chinese export growth may well be the leading edge of this development. In December 2007, growth in Chinese exports to the United States slowed to a 6.8 percent year-over-year rate—only about one-fourth the 26 percent surge in 2006. Reflecting this pullback, the growth in overall Chinese exports slowed to 22 percent—down about 5 percentage points from the 27 percent gain of 2006. With exports accounting for nearly 40 percent of Chinese GDP and the biggest source of global consumption now on the wane, downside risks to the Chinese economy can hardly be ignored. And courtesy of supply-chain linkages, the rest of an increasingly China-centric Asia should now be quick to follow.

The Canadian economy, where exports to the United States account for about 25 percent of its GDP, is also starting to falter, as evidenced by an unexpected decline in Canadian employment in December 2007. For Mexico, where NAFTA-related linkages to the United States are comparable to those of Canada, there are also early signs of a slowdown. Even Europe, one of the brighter spots in the developed world over the

past year, will not be immune to a global slowdown made in America. Germany, long the engine of the European economy, still derives a significant source of its growth from exports. That means the impacts of an external shock made in America, in conjunction with the lagged effects of an appreciating euro, can hardly be minimized. The bottom line for the global economy: When the United States sneezes, the rest of the world can still catch a cold. That's precisely what follows from the cross-border linkages of an increasingly globalized and interconnected world. It makes no sense to preach the gospel of decoupling in an era of globalization.

Perils of Asset-Dependent Economies

At the core of this recession is a distinctly different set of forces from those of the past: It is an outgrowth of one of the most insidious characteristics of an asset-dependent U.S. economy—a chronic short-fall in domestic saving. With America's net national saving averaging a mere 1.4 percent of national income over the past five years, the United States has had to import surplus saving from abroad to keep growing. That means it must run massive current account and trade deficits to attract the foreign capital. This had been a key factor behind an outbreak of mounting global imbalances—an unmistakable by-product of the stresses and strains of America's savings-short economy.

America's aversion toward saving did not appear out of thin air. Waves of asset appreciation—first equities and, more recently, residential property—convinced U.S. citizens that a new era was at hand. Reinforced by a monstrous bubble of cheap credit, there was little perceived need to save out of income. Assets became the preferred vehicle of choice.

With one bubble begetting another, imbalances reached epic proportions in America's savings-short economy. Despite generally subpar income generation, private consumption soared to a record 72 percent real GDP in early 2007. Household debt hit a record 133 percent of disposable personal income. Moreover, income-based measures of personal saving moved back into negative territory in late 2007. And the current account deficit soared to a record \$811 billion in 2006.

None of these trends were sustainable. Many have known this all along. As the imbalances reached rarified territory, it ultimately boiled down to two simple questions: When would they give way and what would it take to spark a long overdue rebalancing? In large part, that's what the current recession is all about.

Asset-Led Rebalancing

A sharp decline in asset prices is necessary to rebalance an increasingly unstable asset-dependent U.S. economy. It is the only realistic hope to shift the mix of saving away from asset appreciation back to that supported by income generation. That could entail as much as a 20- to 30-percent decline in overall U.S. housing prices and a related deflating of the bubble of cheap and easy credit.

Those trends are now under way. Reflecting an outsize imbalance between supply and demand for new homes, residential property prices fell 6 percent in the year ending October 2007 for 20 major metropolitan areas in the United States, according to the S&P Case-Shiller Index. This decline was a harbinger of a broader downturn in nationwide home prices in 2008 that has continued into 2009. Meanwhile, courtesy of the subprime crisis, the credit bubble has popped—ending the cut-rate funding that fuelled the housing bubble.

As home prices move into a protracted period of decline, consumers have finally recognized the perils of bubble-distorted spending and saving strategies. Financially battered households are now responding by rebuilding income-based saving balances. That means the consumption share of GDP will fall, making recession unavoidable.

America's shift back to income-supported saving will be a pivotal development for the rest of the world. As consumption slows and household saving rises in the United States, the need to import surplus saving from abroad will diminish. Demand for foreign capital will recede—leading to a reduction of both the U.S. current-account and trade deficits. The global economy will emerge bruised, but hopefully much better balanced.

The Policy Conundrum

Washington policy makers and politicians need to allow this adjustment to run its course. Policy decisions should not be framed with an eye toward the recessions of yesteryear. The policy options of 2008 must, instead, be considered in the context of America's dual problems of asset bubbles and subpar saving. Unfortunately, that does not appear to be the case. The U.S. body politic is now panicking in response to a likely recession—underwriting massive liquidity injections that could produce another asset bubble and proposing fiscal pump-priming that would depress domestic saving even further. The risk, in my view, is that such actions could backfire—essentially compounding the very problems that got America into this mess in the first place.

That's especially the case for monetary policy. For the Federal Reserve, the current recession is a critical wake-up call. America's central bank has been asleep at the switch for far too long. Ever since the equity bubble began forming in the late 1990s, the Federal Reserve has been ignoring, if not condoning, excesses in asset markets. The Fed has argued that it is best to clean up the postbubble mess rather than prevent an asset class from inflating in the first place. Unfortunately, that approach has allowed the United States to lurch from bubble to bubble. Predictably, the bubbles have gotten bigger, as have the segments of the real economy they have infected. Fixated on targeting a narrow "core CPI," which excludes the necessities of food and energy, the Federal Reserve has ignored at great peril the new and powerful linkages that have developed between economic activity and increasingly risky financial markets.

One key message from the recession of 2008 is that the Federal Reserve needs to rethink its reckless bubble-prone policy before it's too late. The last thing America needs is another asset bubble. And yet that's exactly what another round of aggressive monetary easing might produce. Low nominal interest rates are the sustenance of the excess liquidity that inflates asset bubbles. To escape the trap of multiasset bubbles in a low interest rate climate, counter-cyclical monetary easing needs to be more limited than otherwise might be the case. This could well require more of a Volckeresque discipline of tough money rather than the market-friendly actions of the Greenspan-Bernanke approach. The same goes for the Fed's seemingly open-ended support of unfettered and unregulated financial innovation—a derivatives-based revolution that turned out to have been a good deal riskier than the Greenspan libertarian mantra ever presumed. That's the painful and obvious lesson of the subprime crisis and the lethal contagion into credit markets it has spawned.

Fiscal Policy Constraints

A savings-short U.S. economy also needs to take special care in framing any fiscal-policy response to the current recession. Lacking in domestic funding capacity, I would be in favor of a temporary and targeted fiscal stimulus. The centerpiece of any such package should be expanded unemployment insurance benefits for middle-income workers who lose their jobs—the same workers whose real wages have been stagnant for the better part of a decade. Lacking in saving, a temporary fiscal stimulus is all that the United States can afford. I would categorically rule out any

permanent tax cuts unless they are “revenue neutral”—funded by spending cuts and/or tax increases directed at the upper end of the income and wealth distribution. This is the wrong time to increase America’s still-large structural budget deficit.

Such a targeted fiscal stimulus would have the advantage of injecting a limited increment of purchasing power into the most distressed portion of the income distribution—the innocent victims of yet another post-bubble shakeout. Such a fiscal boost, however, should not be designed with an aim toward propping up personal consumption at unrealistically high and unsustainable levels. That is the last thing a savings-short U.S. economy needs. America needs to reduce excess consumption—not support it. Politics could well complicate a strategy that requires prudence and discipline. And with politicians in both parties now falling all over themselves to come up with the most alluring counter-cyclical remedies, this is a very real concern. But recessions are a time of hardship that require support for those least prepared to cope with cyclical distress. A targeted package is appropriate under these circumstances.

The daunting constraints of America’s unprecedented savings shortfall raise some very tough questions: Who will fund the incremental fiscal stimulus that a savings-short U.S. economy cannot finance on its own? If Washington once again turns to foreign lenders to pick up the tab, will pricing concessions, in terms of the dollar and real long-term interest rates, be required to attract the foreign capital? Foreign investors—both governments and private asset allocators—are now increasingly wary of adding to their overweight dollar positions. Washington’s fiscal spigot should not be opened once again without taking these key risks into serious account. And yet, in its characteristic rush to come up with the miraculous quick fix, neither Congress nor the White House appears to be paying attention to these potentially dire consequences. Further downside risks to the dollar and upward pressure on long-term interest rates cannot be ruled out in such a climate—developments that could well offset all or part of any fiscal stimulus.

The Role of the Dollar

Nor should the currency option be viewed as an antidote to a U.S. recession or as a remedy to the global imbalances stemming from America’s asset-led consumption boom. Notwithstanding the rhetorical flourishes of America’s strong-dollar mantra, Washington has actually accepted the

view that a weaker U.S. dollar is now in the nation's best interest. In large part, so has the rest of the world. After all, at its peak in 2006, America's massive current account deficit absorbed about 75 percent of the world's surplus saving, implying that the United States has been the main culprit behind the destabilizing global imbalances of recent years. It follows, goes the argument, that a weaker dollar should be just the shift in relative prices that an unbalanced U.S. and global economy needs.

Yet there is good reason to doubt this view. I have long been negative on prospects for the dollar, but that's mainly been a market call. In fact, there are severe limits as to what can be expected from a depreciation in the greenback. After all, through early 2008 a broad measure of the U.S. dollar had declined 23 percent since February 2002 in real terms, with only minimal impact on America's gaping external imbalance. Dollar bears argue that more currency depreciation is needed. Moreover, protectionists insist that China—which has the largest bilateral trade imbalance with the United States—should bear a disproportionate share of the next down leg in the U.S. dollar.

This is yet another of Washington's potential policy pitfalls. America's current account deficit is due more to a shortage in saving stemming from bubbles in asset prices than from a misaligned dollar. As a consequence, a lasting resolution of the saving and current account problem will require more of a correction in asset prices than a further depreciation of the dollar. Rebalancing via asset prices is likely to be far more effective in solving America's macroeconomic problems than misplaced emphasis on currency depreciation.

Protectionist Perils

The growing chorus of China-bashers in the U.S. Congress also needs to stand down. America does not have a China problem—it has a multilateral trade deficit with 100 countries. The Chinese bilateral imbalance may be the biggest contributor to the overall U.S. trade imbalance, but, in large part, this is a result of supply-chain decisions by U.S. multinationals. Moreover, the non-Chinese piece of the U.S. trade deficit averaged nearly \$600 billion in 2006–2007—almost two-and-a-half times the size of the Chinese piece. As noted above, America's multilateral trade problem is a key outgrowth of the chronic savings shortfall of an asset-dependent economy. It is simply ludicrous—and increasingly dangerous—to pin the blame on China for America's aversion toward saving.

By focusing incorrectly on the dollar and putting pressure on the Chinese currency, Congress would only shift China's portion of the U.S. trade deficit elsewhere—most likely to a higher-cost producer. That would be the functional equivalent of a tax hike on American workers. If the United States returns to income-based saving in the aftermath of the bursting of housing and credit bubbles, its multilateral trade deficit will narrow and the Chinese bilateral imbalance will shrink. If instead, the Congress opts to use trade sanctions to address U.S. trade problems—a very real possibility in today's climate—the risk of a backlash from America's foreign lenders, like the Chinese, could well intensify. In the event of a pullback in China's demand for dollar-based assets, there could be severe consequences for the U.S. currency and long-term real interest rates. Those are key perils on the slippery slope of trade protectionism—a path that must be avoided at all costs.

Breaking the Daisy Chain

Again, it is important to stress that this is not a garden-variety recession. This downturn is, instead, a painful outgrowth of a savings-short, asset-dependent U.S. economy that has gone to excess. There have been policy and regulatory lapses along the way that have taken the world's largest most powerful economy to this worrisome juncture. But it would be the height of folly to try and address these problems by turning to the same recipes that created the distortions and imbalances in the first place—namely, bubble-prone monetary accommodation and saving-absorbing fiscal stimulus. The cure, instead, must be tailor-made to fit the unique features of the current climate—namely, addressing the excesses of an asset-dependent U.S. economy.

It is going to be a very painful process to break America's addiction to asset-dependent economic behavior—and end the world's addiction to America's asset-led boom. No one wants recessions, asset deflation, and rising unemployment. But this has always been the potential endgame of a bubble-prone, savings-short U.S. economy. And it also has been the greatest flaw of America's excess consumption myth—a scenario that never made sense in an era of subpar income generation. That has long been the message from a gaping current account deficit, a collapse in domestic saving, and record levels of household-sector indebtedness. It was only a question of when the fantasy of an artificial consumption boom would finally come to an end.

The longer the United States puts off this reckoning, the steeper the ultimate price of adjustment. Tough as it is, the only sensible way out is to let markets lead the way. That is what the long overdue bursting of America's asset and credit bubbles is all about. Policy can temporarily cushion the blow for those who will suffer the most, but there is no easy panacea for America's reckless macromanagement of the past decade.

Davos Diary: 2008

January 26, 2008

During the 2008 Annual Meeting of the World Economic Forum in Davos Switzerland, I was invited by the *Financial Times* to contribute to their Davos blog. I filed the following five dispatches, all of which elicited vigorous feedback during a most eventful period.

Will the Fed Rate Cut Work?

JANUARY 22, 2008

Timing is everything, I guess. No sooner had I arrived in Davos, when my Blackberry started chirping with alarms over an emergency 75 basis point Fed rate cut. No new news on the state of the U.S. economy was evident. The only breaking development was a swoon in global equity markets that was likely to be reflected in the form of a similar plunge in the United States. And so the Fed jumped into action. Borrowing a page from the market-friendly script of the Greenspan Fed, Bernanke & Co. offered up a market-friendly action of its own.

Will it work? That's undoubtedly the question that will be hotly debated this year in Davos—a question that I certainly plan to tackle at the opening session on the global economy tomorrow morning. The answer lies in the unique character of this recession. There are two triggers—a bursting of the U.S. house price bubble and a bursting of the credit bubble. I do not believe that aggressive Fed rate cuts will resolve the extreme imbalance between supply and demand in the U.S. property market that will be pushing housing prices lower for some time. Nor do I believe that recent Fed actions will restore the functioning of credit markets to their precrisis state. As a result, pressures are likely to remain intense on housing- and credit-dependent U.S. consumers—a sector that accounts for a record 72 percent of U.S. real GDP.

In essence, the Fed is “pushing on a string” here—unable to stop the recessionary dynamic now unfolding. But there will be consequences in the next recovery: Unfortunately, the U.S. central bank can’t seem to break out of the market-friendly trap it fell into nearly a decade ago. Panicking over the possibility that yet another bubble is bursting, the Fed is once again injecting liquidity into an asset-dependent U.S. economy. That won’t arrest the recessionary dynamic now unfolding, but it could well set the stage for the next asset bubble in America’s bubble-prone economy. Have we learned anything from the mess of the past seven years?

Decoupling or Globalization—But Not Both

JANUARY 23, 2008

Dreams of decoupling danced in the air on this first official day of meetings at Davos. Decoupling, of course, is the latest macro fad—a scenario where the world no longer sneezes when the United States catches a cold. The decoupling enthusiasts were out in full force at the kick-off session on the global economy on Wednesday morning. As a long-standing panelist in this session—with the exception of last year, when only optimists were invited—I didn’t offer much support for this view.

My case is relatively simple. Developing Asia—where the growth dynamic is the strongest and the hopes of resilience are the deepest—remains very much an externally dependent economy. For the region as a whole, exports hit a record high of 47 percent of GDP in 2007—more than double the 19 percent share of 1980. At the same time, private consumption fell to a record low of 48 percent of panregional GDP in 2007—down sharply from the 66 percent reading in 1980. If the fast growing economies of East Asia were truly decoupled, these trends would be the opposite: Export shares would be falling and domestic consumption would be rising.

The decoupling crowd also dreams of alternative sources of global consumption arising from Asia’s two new giants—China and India—that would be more than sufficient to offset a shortfall in U.S. consumption. Don’t count on it. The United States consumed over \$9.5 trillion in 2007—fully six times the combined consumption totals for China (\$1 trillion) and India (\$650 billion). It would be almost mathematically impossible for “Chindia” to fill the void that is likely to be left by a consolidation of the American consumer. For externally led Developing Asia, the proverbial sneeze in the face of a U.S. cold is more likely than not.

Maybe that's what the recent sharp correction in Asian equity markets is all about.

In the Q & A part of the session, howls of protest came from representatives of Latin America, Central Europe, and even Asia. The European decoupling advocates accosted me in the halls outside the session. Yet globalization, long the mantra of Davos, is all about increased integration of the global economy through trade and capital flows. As I said to one of the more hopeful, "You either believe in decoupling or globalization—but not both."

Being Right on the Economy—At Last

JANUARY 24, 2008

At the end of a long first day in Davos, one phrase is ringing in my ears: "Well, you're finally right." The subtext, of course, is a thinly veiled critique of my long-standing bearish view on the U.S. economy—an economy that I have characterized repeatedly as unbalanced, income-short, overly indebted, saving deficient, bubble prone, and all those other lovely attributes of a nation that I believe has long been living beyond its means.

Of course, the jury is still out on whether this is that proverbial moment of reckoning. It certainly feels like the Great Moderation is now giving way to the Great Unraveling. But I've been through enough of these situations over the years to know that you can never underestimate the inherent resilience of a Teflon-like U.S. economy. America has dodged tough bullets before and it could certainly happen again. But in the aftermath of the simultaneous bursting of monstrous housing and credit bubbles, my macro framework is finally flashing something darn close to a breaking point.

Small consolation, some might say. After all, for traders and short-term-oriented investors, being early is often judged as the functional equivalent of being wrong. On that basis, I would be the first to concede that my bearish call on the United States has been lacking in one critical respect: While the events that are now unfolding suggest that my basic macro framework appears to have been correct, I have hardly distinguished myself in getting the timing right.

Confession time. At the risk of sounding overly defensive, my own experience is testament to one of the greatest flaws of macro—the timing dimension of any call. Let's face it, with few exceptions, we macro

folk are not good traders. My approach has always been grounded in analytics—focusing more on the tensions that arise from economies in disequilibrium. My basic supposition is that these tensions eventually reach a breaking point, triggering corrections that return an economy to a more sustainable equilibrium. The how's and why's of that breaking point, or trigger, are invariably the stuff of exogenous shocks—the bolt from the blue that I find almost impossible to predict with any accuracy.

The key for me is the framework and the tensions. Get those right and you stand a much better chance of nailing the big macro calls. The risk is that you're always early. But when the turn finally comes, you are in a much better position to understand it and to be prepared for the consequences. Being finally right has its benefits, too.

Sovereign Wealth Funds: Can Beggars Really Afford to Be Choosy?

JANUARY 25, 2008

Why all the fuss about Sovereign Wealth Funds (SWFs)? This is one of the thorniest issues being debated in Davos this year. And there was plenty of tension in the air in a packed session on Thursday morning, when representatives from several leading SWFs came face-to-face with an anxious West.

It's not so much the scale of this new class of investors—with SWF assets under management currently estimated at around U.S. \$2.9 trillion and estimated by some to climb to U.S. \$12 trillion by 2015. It's simply the fear of foreign ownership posed by this increasingly powerful group of state-controlled asset managers. Sadly, it boils down to nothing more than a thinly veiled manifestation of financial protectionism.

The pushback on SWFs from the United States is especially disconcerting. A savings-short U.S. economy is the world's largest external borrower—still requiring roughly U.S. \$3 billion of foreign capital inflows per business day to fund a massive current account deficit. Traditionally, those inflows have been lodged primarily in low-yielding U.S. Treasuries. But America's foreign lenders—largely poor developing countries—have become rightfully convinced in recent years that they need higher yields on their investments. And, so, following the basic precepts of modern portfolio theory, diversification into higher-yielding assets is now under way.

This is the red flag for protectionists. The experiences of the ill-fated foreign acquisition attempts of American assets by China's CNOC and

Dubai Ports World still ring in the air of an increasingly xenophobic body politic in the United States. Such concerns are a great mystery. In fact, there is not one shred of evidence of an SWF recently deploying its capital for strategic or geopolitical purposes. Their interests are largely in minority, nonvoting stakes that provide relatively high and safe rates of return. As one representative of a leading SWF from the Middle East protested, "These fears are based purely on assumption." Fair point.

Some Western politicians are demanding that, at a minimum, SWFs agree to a new code of conduct that establishes their collective commitment to basic principles of transparency, potential conflicts, and other dimensions of corporate governance. Rather interesting that the same demands have not been made on hedge funds and private equity investors. But an even deeper question emerges for savings-short Washington who seems quite willing to dictate both the terms and the form of capital that is received from America's foreign lenders: Can beggars really afford to be so choosy?

You Can't Keep a Good Optimist Down

JANUARY 26, 2008

It's hard to keep a good optimist down. And they didn't stay down for long. Over the course of this year's World Economic Forum, there was a distinct mood change. As I read the Davos crowd, the sentiment seemed to shift from despair on Wednesday to guarded optimism by Friday.

I have to confess that I don't always trust myself as an objective barometer in reading the collective mindset at such a large gathering. So I checked out my assessment with a few trustworthy and objective observers, and they corroborated my observation.

As one of the kick-off speakers on Wednesday, I guess I played a role in setting a rather dour tone at the beginning of this year's events. For a few hours, I encountered no pushback whatsoever from those passing in the halls. But then the crowd started to get more aggressive in challenging my case.

The main reason behind this mood swing was trust in the authorities. The combination of a shockingly aggressive Fed easing, together with quick U.S. congressional agreement on a \$150 billion fiscal stimulus package, left the Davos crowd feeling that not all was lost on prospects for the U.S. economy after all. Suddenly, the recession call that seemed so convincing on Wednesday seemed far more unlikely on Friday. And if

the United States is able to avoid a downturn, went the argument, then the global decoupling debate was suddenly irrelevant.

I was quick to counter. Arresting the recessionary dynamic now under way in the United States is not like stopping a washing machine in mid-cycle, I argued.

The two most powerful forces now at work—the bursting of property and credit bubbles—are not likely to be arrested by aggressive monetary and fiscal easing. As the support from asset markets and easy credit wanes, housing-dependent American consumers still seem likely to bring consumption into closer alignment with income generation. This rebalancing should, in turn, lead to a meaningful reduction in the record 72 percent of U.S. real GDP that is currently earmarked for personal consumption—the critical ingredient in the recession of 2008.

In part because of lags, Washington's policy package should have more of an impact on the next recovery. And there are no guarantees that such impacts will be quite the ray of sunshine the Davos crowd was starting to envision.

Aggressive monetary easing sets the stage for yet another bubble-led recovery. And fiscal stimulus for a savings-short U.S. economy puts the onus, once again, on foreign lenders to pick up the tab. In short, it's "same old, same old" in Washington—hardly a comforting sign that U.S. authorities have learned much of anything from another bubble-induced implosion.

As I was leaving the Congress Centre in Davos for the final time this year, one of my oldest central banker friends pulled me aside. "You were too hard on Ben (Bernanke)," he said. "He really had no choice other than to act in support of the markets. I would have done the same." Around the world, market-friendly central bankers stand shoulder to shoulder in their penchant to keep the magic alive for an asset-dependent world. Time to get out of Davos.

Double Bubble Trouble

March 5, 2008

Amid increasingly turbulent credit markets and ever-weaker reports on the economy, the Federal Reserve has been unusually swift and determined in its lowering of the overnight lending rate. The White House and Congress have moved quickly as well, approving rebates for families and tax breaks for businesses. And more monetary easing from the Fed could well be on the way.

The central question for the economy is this: Will this medicine work? The same question was asked repeatedly in Japan during its “lost decade” of the 1990s. Unfortunately, as was the case in Japan, the answer may be, “No.”

If the American economy were entering a standard cyclical downturn, there would be good reason to believe that a timely countercyclical stimulus like that devised by Washington would be effective. But this is not a standard cyclical downturn. It is a postbubble recession.

The United States is now going through its second postbubble downturn in seven years. Yet this one stands in sharp contrast to the postbubble shakeout in the stock market during 2000 and 2001. Back then, there was a collapse in business capital spending, a sector that peaked at only 13 percent of real GDP.

The current recession has been set off by the simultaneous bursting of property and credit bubbles. The unwinding of these excesses is likely to exact a lasting toll on both homebuilders and American consumers. Those two economic sectors collectively peaked at 78 percent of GDP, or fully six times the share of the sector that pushed the country into recession seven years ago.

For asset-dependent, bubble-prone economies, a vigorous cyclical recovery—even when assisted by aggressive monetary and fiscal accommodation—isn’t a given. Over the six years ending in mid-2007, income-short consumers made up for the weak increases in their paychecks by

extracting equity from the housing bubble through cut-rate borrowing that was subsidized by the credit bubble. That game is now over.

Washington policy makers may not be able to arrest this postbubble downturn. Interest rate cuts are unlikely to halt the decline in nationwide home prices. Given the outsize imbalance between supply and demand for new homes, housing prices may need to fall an additional 20 percent to clear the market.

Nor have aggressive interest rate cuts done much to contain the lethal contagion spreading in credit and capital markets. Now that their houses are worth less and loans are harder to come by, hard-pressed consumers are unlikely to be helped by lower interest rates.

Japan's experience demonstrates how difficult it may be for traditional policies to ignite recovery after a bubble. In the early 1990s, Japan's property and stock market bubbles burst. That implosion was worsened by a banking crisis and excess corporate debt. Nearly 20 years later, Japan is still struggling.

There are eerie similarities between the United States now and Japan then. The Bank of Japan ran an excessively accommodative monetary policy for most of the 1980s. In the United States, the Federal Reserve did the same thing beginning in the late 1990s. In both cases, loose money fueled liquidity booms that led to major bubbles.

Moreover, Japan's central bank initially denied the perils caused by the bubbles. Similarly, it's hard to forget the Fed's blasé approach to the asset bubbles of the past decade, especially as the subprime mortgage crisis imploded last August.

In Japan, a banking crisis constricted lending for years. In the United States, a full-blown credit crisis seems to be doing the same.

The unwinding of excessive corporate indebtedness in Japan and a "keiretsu" culture of companies buying one another's equity shares put extraordinary pressures on business spending. In America, an excess of household indebtedness could put equally serious and lasting restrictions on consumer spending.

Like their counterparts in Japan in the 1990s, American authorities may be deluding themselves into believing they can forestall the end-game of postbubble adjustments. Government support is being aimed, mistakenly, at maintaining unsustainably high rates of personal consumption. Yet that's precisely what got the United States into this mess in the first place—pushing down the savings rate, fostering a huge trade deficit, and stretching consumers to take on an untenable amount of debt.

A more effective strategy would be to try to tilt the economy away from consumption and toward exports and long-needed investments in infrastructure. That won't be easy to achieve. Such a shift in the mix of the economy will require export-friendly measures like a weaker dollar and increased consumption by the rest of the world, which would strengthen demand for American-made goods. Fiscal initiatives should be directed at laying the groundwork for future growth, especially by upgrading the nation's antiquated highways, bridges, and ports.

That's not to say Washington shouldn't help the innocent victims of the bubble's aftermath—especially lower- and middle-income families. But the emphasis should be on providing income support for those who have been blindsided by this credit crisis rather than on rekindling excess spending by overextended consumers.

By focusing on exports and on infrastructure spending, we might be able to limit the recession. Such an approach might also set the stage for a more balanced and sustainable economic upturn in the next cycle. A stimulus package aimed at exports and infrastructure investment would be an important step in that direction.

The toughest, and potentially most relevant, lesson to take from Japan's economy in the 1990s was that the interplay between financial and real economic bubbles causes serious damage. An equally lethal interplay between the bursting of housing and credit bubbles is now at work in the United States.

American authorities, especially Federal Reserve officials, harbor the mistaken belief that swift action can forestall a Japan-like collapse. The greater imperative is to avoid toxic asset bubbles in the first place. Steeped in denial and engulfed by election-year myopia, Washington remains oblivious of the dangers ahead.

■ Even When the Worst Is Over—Watch Out for Aftershocks

April 15, 2008

Every financial crisis is different, but at some point, they all end. It is hard to know if the end of this one is at hand, but there are grounds to believe the worst of the firestorm may be burning itself out.

Among the reasons: liquidity injections by central banks, especially the U.S. Federal Reserve, have erred on the side of overkill. Moreover, some of the actions have been unconventional, especially the opening of the Fed's discount window to investment banks for the first time since the 1930s.

Also, the failure of Bear Stearns is reminiscent of similar catharses that have marked the bottom of earlier crises, from the failure of Herstatt Bank in 1974 to the demise of Long-Term Capital Management in 1998.

However, there is far more to the macro endgame. This crisis has been big enough to have triggered a host of feedback effects that should endure long after financial markets begin to heal.

First and foremost, there is the impact on the real economy. This is particularly true of the United States, where income-deficient, housing-dependent consumers are caught in a vice between a cyclical erosion of labor income and the bursting of housing and credit bubbles. Add to that a steep recession of homebuilding activity, and risks have tipped decidedly to the downside for fully 78 percent of the U.S. economy. As a result, corporate profits should fall well below expectations, especially for the nonfinancial component of the S&P 500. As indicated by the recent earnings shortfall at General Electric, such optimism, in the face of recession, points to especially painful feedback effects for the stock market.

Second, there are lagged impacts on the broader global economy. In an era of globalization, the world economy has become tightly linked through cross-border flows of trade, financial capital, information, and labor. Export-led Developing Asia has been a big beneficiary of the surge in global demand and world trade over the past five-and-a-half years. Now that the global business cycle has turned, Asia will have a very hard time decoupling itself from a consolidation of the U.S. consumer.

Third, it seems quite likely that bruised and battered financial institutions will have to contend with an additional round of pressures. Until now, financial intermediaries have been hit mainly by crisis-related disruptions on the credit front. But as is typically the case with erosion on the demand side of the real economy, a cyclical deterioration in loan quality for households and businesses is coming.

Fourth, feedback effects could also hit commodity markets—the sole surviving bubble in an increasingly bubble-prone world. By now, most are convinced that commodities are in a permanent “super cycle,” with the limited expansion of supply failing to keep up with a growing appetite on the demand side of the equation sparked by commodity-intensive economies such as China and India. However, with global GDP growth in 2008–2009 likely to fall well short of the near 5 percent average pace of the past five years, a cyclical correction in the economically sensitive prices of oil, base metals, and other nonfood commodities seems likely.

Fifth, a political backlash to this crisis is likely to lead to a new wave of re-regulation. Just as the bursting of the dot-com bubble and an outbreak of corporate accounting scandals led to passage of Sarbanes-Oxley Act of 2002, U.S. politicians now seem equally committed to a recasting of the regulatory framework governing financial markets. The U.S. Treasury has already fired an opening salvo in what is likely to be an intense and drawn-out debate. As an added twist, look for the U.S. Congress to rewrite the Fed’s policy mandate to make the central bank more accountable for avoiding destabilizing asset bubbles in the future.

Financial markets have breathed a sigh of relief that the worst may now be over. Maybe that is the case for the crisis, itself.

But do not confuse that possibility with an all-clear sign for the real economy, stock markets, or the political cycle. As the United States slips into recession, a chain of increasingly powerful feedback effects is likely to follow. The after-shocks of this crisis will shape the landscape for years to come.

Postscript: Obviously, the worst was far from over with the demise of Bear Stearns. The failure of Lehman Brothers—some six months later—now stands as

the most prominent monument of a failed industry. Hopefully, that precedent will not be surpassed—although one of the key lessons of this crisis is, never say never. Even so, the basic premise described above still stands—the macro impacts of this crisis have now shifted from financial services firms to the real side of the U.S. and global economy. These feedback effects will likely endure for years to come.

Pitfalls in a Postbubble World

August 1, 2008

A year ago, there was barely an inkling of what was about to transpire in world financial markets and the global economy. There were some early warning signs that all was not well in the subprime slice of the U.S. mortgage market. But as was the case of the dot-com bubble in early 2000, subprime was widely judged to be of little consequence for the macro story. The broad consensus of consumers, business people, policy makers, and politicians ignored simmering problems on the subprime front and believed that the global boom of the preceding five years was very much intact.

Alas, similar to circumstances in 2000, the bloom is now off the rose—the postbubble global business cycle has turned. World GDP growth, which averaged close to 5 percent annually over the 2004–2007 period—the strongest four consecutive years of global growth since the early 1970s—now seems headed back down into the 2 percent range for the next three years. Such a growth pace would fall far short of the 45-year trend of 3.7 percent in world GDP growth. And it would mark a stunning deceleration for a world that had become convinced in the permanence of the new global growth boom.

The interplay between financial markets and the real economy undoubtedly holds the key to the global macro outlook over the next few years. I have found it helpful to break down the prognosis into three stages:

The credit crisis is the first stage. Sparked by the subprime meltdown in the Summer of 2007, an unprecedented cross-product contagion quickly spread to asset-backed commercial paper, mortgage-backed securities, structured investment vehicles (SIVs), interbank offshore (LIBOR) financing, leveraged lending markets, auction rate securities, so-called monoline insurers, and a number of other opaque products

and structures. Unlike the Asian financial crisis 10 years earlier, which was a powerful cross-border contagion, the “originate and distribute” characteristics of today’s complex instruments and structures ended up infecting offshore investors as well. That puts the current crisis in the rarefied breed of being both cross-product and cross-border. United States financial institutions generally have been aggressive in marking down the value of distressed securities. Largely for that reason, I believe that this first phase is about 60 percent complete—more behind the United States than ahead of it but still a good deal more to come as the business cycle now kicks in and produces yet another round of earnings impairment for financial intermediaries.

The second stage reflects the impacts of the credit and housing implosions on the real side of the U.S. economy. The main event here is the likely capitulation of the overextended, savings-short, overly-indebted American consumer. For nearly a decade-and-a-half, real U.S. consumption growth averaged close to 4 percent per year. As asset-dependent consumers now move to rebuild income-based saving and prune outsize debt burdens, a multiyear downshift in consumer demand is likely. Over the next two to three years, I expect trend consumption growth rate to be around 1.5 percent. There will be quarters when consumer spending falls short of that bogey and the U.S. economy remains mired in recession. There will undoubtedly also be quarters when consumption growth is faster than the 2 percent norm and it will appear that a recovery is under way. Such rebounds, unfortunately, should prove short lived for postbubble American consumers. This aspect of the macro-adjustment scenario has only just begun—suggesting that Phase II is only about 20 percent complete.

The third stage is a global phase—underscored by the linkages between the U.S. consumer and the rest of the world. Due to cross-border trade lags, those linkages are only now just beginning to play out. Early impacts are already evident in China, where GDP growth slowed to 10.1 percent in the second quarter of 2008 on the back of a compression of export growth to the United States. As Japan and Europe now weaken—collectively accounting for about 30 percent of China’s total exports—heretofore-resilient pieces of Chinese external demand will also begin to falter, possibly prompting another down leg in Chinese GDP growth from 10 percent to 8 percent within the next six months. A similar story is likely for Japan. Overall Japanese export volume growth went negative in June 2008 (–1.6 percent year-over-year) for the first

time in 16 months. At work was emerging sluggishness in Japanese exports to Europe and elsewhere in Asia—once resilient markets that previously had been masking emerging weakness to the United States.

China and Japan are at the opposite ends of Asia's external vulnerability chain. China has a huge cushion—nearly 12 percent growth over the past two years—to ward off the blow of an external shock. Japan, by contrast has been only a 2 percent growth economy in recent years and has no such cushion. In a weaker external demand climate, the downside to Chinese economic growth appears to be around 8 percent. For Japan, the downside is probably closer to zero—underscoring the distinct possibility of a recessionary relapse in Asia's largest economy. Phase III currently appears to be only about 10 percent complete.

In short, this macro crisis is far from over. As the United States now adjusts to much tougher postbubble realities, the rest of an interdependent world should follow. Moreover, there are undoubtedly feedback effects between the three stages—especially between the credit cycle and debt-dependent economies in the United States and around the world. All in all, macro adjustments should last well into 2009 and probably spill over into 2010.

Financial Market Implications

The events of the past year have certainly not been lost on financial markets. As forward looking discounting mechanisms, much of the macro adjustments that have unfolded are now discounted in the price of major asset classes. But denial remains deep about the full extent of the adjustments. To the extent that there is more to come in the global economy, the same can be said for financial markets. Four broad conclusions in that regard:

With equity markets now in bear-market territory in most parts of the world, it is tempting to conclude that the worst is over. I am suspicious of that prognosis. The trick is to resist the temptation to view equity markets as a homogenous asset class. The distinction between financials and nonfinancials is critical. The former have certainly been beaten down. That is not the case for nonfinancials, however. For example, consensus earnings expectations for the nonfinancials component of the S&P 500 are still centered on prospects of close to 25 percent earnings growth over 2007–2008. As U.S. economic growth falters, however, I expect earnings risks to tip to the downside for nonfinancials—underscoring the distinct possibility of yet another

important down leg in global equity markets. The equity bear market is likely to shift from financials to nonfinancials.

For bonds, the prognosis centers on the interplay between inflation and growth risks—and the implications such a tradeoff has for the policy stance of central banks. As inflation fears have mounted recently, yields on sovereign government bonds rose as market participants started to discount a return to more aggressive monetary policy stances of major central banks. In a faltering growth climate, I suspect cyclical inflation fears will end up being overblown and monetary authorities will become fearful of overkill. Over the near term, major bond markets could rally somewhat on the heels of a rethinking of the aggressive central bank tightening scenario. Over the medium term, I concede that the jury is still out on stagflation risks, especially in inflation-prone developing economies. The bond market prognosis is more uncertain over that time horizon.

For currencies, the dollar remains center stage. I have been a dollar bear for over six years for one reason—America's massive current account deficit. While the U.S. external shortfall has been reduced somewhat over the past year-and-a-half—largely for cyclical reasons—at 5 percent of GDP, it is still far too large. And so I remain fundamentally bearish on the dollar. At the same time, it appears that the dollar has overshot on the downside over the past year on the fear that subprime is mainly a U.S. problem. As the global repercussions of the macro crisis now spread, I believe that investors will rethink the belief that they can seek refuge in euro- and yen-denominated assets. As a result, I could envision the dollar actually stabilizing or possibly even rallying into year-end 2008 before resuming its current-account induced decline in 2009.

The commodity market outlook is especially topical these days. A year from now, I believe that economically sensitive commodity prices—oil, base metals, and other industrial materials—will be a good deal lower than they are today. Two reasons—a marked deceleration in global growth leading to an improvement in the supply-demand imbalance, as well as a pullback in commodity buying by return-seeking financial investors. At work in this latter instance are mainly long-only, real-money institutional investors such as global pension funds—all of whom have been advised by their consultants to increase their asset allocations into commodities as an asset class. Such herding behavior of institutional investors invariably turns out to be wrong—underscoring the possibility of an investor pullback from this asset class that would reinforce shifting economic

fundamentals. Soft commodities—mainly agricultural products—as well as precious metals could well be exceptions to a likely cyclical softening in economically sensitive commodity markets.

Perpetuating the Madness?

The current financial crisis is hardly lacking in superlatives. Whether it is truly the worst debacle since the Great Depression, as many have argued, remains to be seen. But it is certainly a watershed event—especially since it draws into sharp question the fundamental underpinnings of a U.S. economy that has long ignored its imbalances and excesses. Sadly, America's body politic seems both unwilling and unable to fathom the magnitude of the problems that have come to a head in this crisis.

Tax policy is a case in point. Rebates to overextended American consumers have been the first line of defense, and there is new talk in Washington of a second round of such stimulus measures. Yet with personal consumer spending hitting a world record 72 percent of real GDP in 2007, the government's injections of spendable income are aimed at perpetuating the biggest consumption binge in modern history. For a nation that desperately needs to save more and spend less—and thereby pay down debt and reduce its massive current account deficit—politically expedient personal tax cuts are the wrong medicine at the wrong time.

Washington's response to the housing crisis is equally problematic. The Congress has made foreclosure containment a centerpiece of the fix. This is consistent with a philosophy that has long stressed ever-rising rates of home ownership as a key objective of U.S. public policy. Yet an obvious and painful lesson of the subprime crisis is that there are some Americans who simply cannot afford to purchase a home. Foreclosure is a tragic, but ultimately necessary, consequence of misguided home buying. For low-income victims of the housing bubble, assistance should be directed at income support rather than at perpetuating uneconomic home ownership. By opting for the latter, Congress is inhibiting the requisite decline in home prices that ultimately will be necessary to clear the market and bring the housing crisis to an end.

Nor have the financial authorities distinguished themselves in this crisis. Once again, Washington is condoning undisciplined risk taking through actions that temper the consequences of the bursting of the risk bubble. In effect, the authorities are shielding irresponsible risk takers and thereby enabling the moral hazard that has become increasingly

ingrained in today's financial culture. At the same time, a Federal Reserve that continues to ignore the perils of asset bubbles in the setting of monetary policy is guilty of reckless endangerment to the financial markets and to an increasingly asset-dependent U.S. economy.

In short, Washington has responded to this financial crisis with a politically driven, reactive approach. This does little to change bad behavior. Far from heeding the tough lessons of an economy in crisis, Washington is doing little to break the daisy chain of excesses that got America into this mess in the first place.

More than anything, America now needs tough love—a new course that owns up to years of excess and accepts the remedies those excesses now require. It is not that difficult to fathom the broad outlines of what that new approach might entail—more saving, as well as more investment in both people and infrastructure. An energy policy might be nice as well—as would be more prudent stewardship of the financial system. This program won't win any popularity contests, but in the end, it is America's only hope for a sustainable postbubble prosperity.

Lessons

It didn't have to be this way. America went to excess, and the rest of an export-dependent world was more than happy to go along for the ride. Policy makers and regulators—the stewards of the global economy—looked the other way and allowed the system to veer out of control. Investors, businesspeople, financial institutions, and consumers were all active participants in the Era of Excess.

The key question going forward is whether an adaptive and increasingly interrelated global system learns the tough lessons of this macro upheaval. At the heart of this self-appraisal must be a greater awareness of the consequences of striving for open-ended economic growth. The United States could not hit its growth target the old fashioned way by relying on internal income generation, so it turned to a new asset- and debt-dependent growth model. For its part, export-dependent Developing Asia took its saving-led growth model to excess: Unwilling or unable to stimulate internal private consumption, surplus capital was recycled into infrastructure and dollar-based assets—in effect, forcing super-competitive currencies and exports to become the sustenance of a new development recipe.

This crisis is a strong signal that these strategies are not sustainable. They have led to multiple layers of excess—underscored by a precarious

interplay between internal and external imbalances within and between the world's largest economies. It took unsustainable credit and risk bubbles to hold this system together in an unstable equilibrium. But now those bubbles have burst, unmasking a worrisome disequilibrium that demands a new approach to policy and an important shift in behavior by households, businesses, and financial-market participants.

Financial and economic crises often define some of history's greatest turning points. They can be the ultimate in painful learning experiences. But if all the authorities can do is opt for the politically expedient quick fix, a globalized world will have squandered a critical opportunity to put its house in order. That would be the ultimate tragedy. If this crisis demonstrates anything, it is that it only gets tougher and tougher to pick up the pieces in a postbubble world.

Panic of 2008: Enough Scapegoating

October 1, 2008

In my more than 35 years as a professional economist, I have endured five recessions and about a dozen financial crises. Yet never has one hit this close to home. That makes the experience personal, which runs the added risk of coloring the judgment of the cold calculating analyst that I like to think I am. But here's a shot, in any case.

While we have been in a credit crisis for more than 14 months, there can be no mistaking the telltale signs of the panic phase of this crisis that first became evident in the week of September 15, 2008. We are in the midst of what the academic Charles Kindleberger called the “revulsion stage” of a crisis—indiscriminate and contagious selling of distressed assets that leads “banks to stop lending on the collateral of such assets.”² When such fear grips the markets, investors (and speculators) are quick to generalize—punishing many for the sins of few. That's the most dangerous phase of any crisis—when market implosions start to take on a self-reinforcing life of their own.

The most important thing I can say about financial panics is that they are all temporary—they either die of exhaustion or are overwhelmed by the heavy artillery of government policies. That raises the most important question of all: What will it take to bring this panic to an end? Kindleberger, again, lays it out very clearly. He argued that financial panics tend to feed on themselves until one or more of three things happen: (1) prices fall to depths that bring investors back into distressed assets; (2) exchanges are closed; (3) central banks spring into action. Right now, progress is not encouraging on any of those counts.

2. See Charles Kindleberger, *Of Manias, Panics, and Crashes: A History of Financial Crises*. Hoboken, NJ: John Wiley & Sons, 2005.

That's particularly true of the liquidity injections proposed by U.S. fiscal authorities—the so-called Emergency Economic Stabilization Act of 2008 that was surprisingly rejected by the U.S. House of Representatives on September 29. With financial markets melting down in the aftermath of Congress' politicization of this crisis, I have a sneaking suspicion that U.S. politicians will now quickly change their minds and vote to approve this plan in the next few days. And that will most assuredly benefit the most illiquid portions of increasingly dysfunctional credit markets.

Unfortunately, the so-called Congressional fix is deficient in several key respects. That's especially the case with respect to the scope of the package. The original Paulson Plan was set at \$700 billion. Yet the congressional version proposed a down payment of only \$250 billion and offered up the remainder in two separate tranches—one tied to presidential approval and the other dependent on a new congressional authorization. During times of crisis and panic, the policy response should err on the side of overkill. This approach erred on the side of underkill.

Furthermore, a policy response should also be unmistakably direct in its focus to arrest markets in disarray. The original Paulson plan of three-and-a-half pages erred with its lack of specificity. But at least it was unmistakably clear in taking dead aim on dysfunctional mortgage and credit markets. Congress responded with 110 pages of legislation, complete with added stipulations on equity warrants for participating institutions, restrictions on executive compensation, a supplementary insurance scheme, and four new bureaucratic oversight functions. This dilutes the thrust of the policy response and blunts its impact on market angst.

With the fiscal package falling short on those counts, the burden for a crisis fix is now likely to fall more acutely on monetary policy. In times of extreme crisis—and that is most assuredly the case today—the central bank needs to make a strong and unequivocal statement that it is prepared to do everything in its power as a lender of last resort.

Specifically, I think the Fed needs to borrow a page from the Greenspan script of the Crash of 1987 and send a direct and simple message of open-ended liquidity support to markets in crisis. At the same time, it should make a strong symbolic move by cutting its policy rate by 50 basis points immediately to let the markets know it takes this matter very seriously. And the Fed should enlist other major central banks to join in a rare coordinated policy action.

I am convinced that such a powerful monetary policy response, in the face of a suboptimal fiscal response, would go a long way in stopping

the madness that is now gripping financial markets. Such actions would also go a long way in tempering the collateral damage that is now being inflicted on the U.S. and broader global economy. Fed Chairman Ben Bernanke is supposedly one of the most renowned living experts on the Great Depression. He knows better than anyone that the most important lesson of all from that earlier period was a series of major policy blunders by America's central bank. That knowledge now needs to be put to work.

Today's Fed is hardly an innocent bystander to this mess, especially in light of the role it played in condoning the excesses of the past decade. Is it doomed to stay that course, as well as repeat the errors of the 1930s? My bet is a resounding "No"—but it's high time for Bernanke to dispel any doubts once and for all. And, it's high time for the U.S. Congress to put aside the politics of scapegoating and get on with the heavy lifting of crisis containment. The alternative is simply unacceptable.

Global Fix for a Global Crisis

October 9, 2008

There is no longer any middle ground. An ever-deepening crisis spells one of two things—the distinct possibility of a wrenching downturn in the global economy or an opportunity for healing and recovery. The ball is in the court of the authorities.

The rare coordinated easing by the world's leading central banks on October 8, 2008—50 basis point rate cuts by the Fed, the ECB, and central banks in Canada, England, Sweden, and Switzerland—was an important step in the right direction. The risk is that it may not have been enough.

This crisis is so grave and so threatening that it is critical that policy err on the side of overkill, not underkill. That is true of both monetary and fiscal policy alike.

I would have preferred to have seen rate cuts of twice the magnitude that were announced on that Wednesday—leaving no mistake about the power of the weapons being deployed as well as the collective resolve of the stewards of the global economy.

I would also have preferred that a blanket statement had been issued by the world's leading central banks, saying that they are collectively prepared to backstop global liquidity in the broadest sense. This endorsement should also include the cash (but not derivatives) markets of counterparty risk.

But central banks can't do the job alone. Follow-up efforts are needed. Specifically, I would also like to see a coordinated initiative endorsed by the world's leading fiscal authorities announced this coming weekend at the G-7/IMF/World Bank meetings in Washington. Such an initiative should include a commitment to recapitalize a seriously weakened global banking system. It should also offer public sector support to mortgage holders with negative equity positions as well as propose a sweeping review of mandates for regulatory policy, monetary policy, and global risk management practices.

There would be enormous benefits from such a combined monetary and fiscal fix. It would be the functional equivalent of a massive tax cut for a crisis-torn global economy. It would unclog the clogged arteries in credit markets. It would put financial institutions on sounder footing. It would provide some visibility to the bottom of the global business cycle. And it would usher in a new era of transparency, improved disclosure, improved underwriting standards, and enhanced oversight. It would also provide a new focus on financial stability and greater accountability and discipline in an all-too-reckless world.

Notwithstanding my long-standing bearishness on the global economy and world financial markets, I am now actually hopeful that the world is at a critical turning point. We have gone to the edge of an abyss that few thought was ever possible. Having stared into the darkness, the authorities hopefully have a better appreciation of what is truly at stake. It is not too late. If the world now pulls together, we can avoid the Armageddon endgame.

We didn't have to come this close to disaster. Steeped in denial, policy makers around the world were operating largely in an ad hoc mindset—coping with asset- and institution-specific issues as they arose on a case-by-case basis. That may have worked in crises of the past—but not this time. The reactive and incremental approach has to be replaced by one that is proactive and powerful—in essence, deploying all of the firepower in the policy arsenal. This is definitely not a time to keep ammunition in reserve.

In the end, this is not just a crisis of markets, financial institutions, risk management, and regulators. It is a crisis of leadership. Looking to the upcoming G-7 meeting, the authorities who gather in Washington this weekend should be locked in a room until they come up with a true global fix for this mother of all global crises. Incrementalism is not an option. If world leaders follow such a course, there is legitimate hope for a new global healing and eventual recovery. It is premature to bank on such an optimistic outcome. But if that turns out to be the case, the world must also be mindful of the pitfalls of any postbubble recovery—avoiding at all costs the enduring excesses of liquidity and risk appetite that finally brought the system to its knees. There will be no second chance.

Changing the Fed's Policy Mandate

October 28, 2008

A regulatory backlash is now under way as the U.S. body politic comes to grips with the financial crisis. Wall Street—or what is left of it—is first in the line of fire. But the era of excess was as much about policy blunders and regulatory negligence as about mistakes by financial institutions. As Washington creates a new system, it must also redefine the role of the Federal Reserve.

Specifically, the U.S. Congress needs to alter the Fed's policy mandate to include an explicit reference to financial stability. The addition of those two words would force the Fed not only to aim at tempering the damage from asset bubbles but also to use its regulatory authority to promote sounder risk management practices. Such reforms are critical for a postbubble, crisis-torn U.S. economy.

This is not the first time the U.S. Congress has needed to refine the Fed's mandate. After the great inflation of the 1970s, the so-called Humphrey-Hawkins Act of 1978 was enacted. That required the Fed to add price stability to its original post-World War II policy target of full employment. In the late 1970s, Congress felt the Fed needed the full force of the law to tackle a corrosive inflation problem. This legislative change empowered Paul Volcker, a later Fed chairman, in his courageous assault on double-digit inflation.

By focusing on financial stability, the Fed will need to adjust its tactics in two ways. Firstly, monetary policy will need to shift from the Greenspan-Bernanke reactive, postbubble clean-up approach toward preemptive bubble avoidance. Second, the U.S. central bank will need to be tougher in enforcing its neglected regulatory oversight capacity.

By adding financial stability to the Fed's policy mandate, I am mindful of the pitfalls of multiple policy targets. However, single-dimensional policy targeting does not cut it in a complex world. As such, the Fed will need to be creative in achieving its mandated goals—using monetary policy, regulatory oversight and enforcement, and moral persuasion. Just as the Fed has been reasonably successful in its twin quests for price stability and full employment, I am confident it can rise to the occasion with the addition of financial stability to its mandate.

I am not suggesting the Fed develop numerical targets for asset markets. It should have discretion about how it interprets the new mandate. Yes, it is tricky to judge when an asset class is in danger of forming a bubble. But hindsight offers little doubt of the bubbles that developed over the past decade—equities, residential property, credit, and other risky assets. The Fed wrongly dismissed these developments, harboring the illusion it could clean up any mess later. Today's problems are a repudiation of that approach.

There is no room in a new financial stability mandate for bubble denials such as Alan Greenspan, the former Fed chairman. He argued that equities were surging because of a new economy; that housing forms local not national bubbles, and that the credit explosion was a by-product of the American genius of financial innovation. In retrospect, while there was a kernel of truth to all of those observations, they should not have been decisive in shaping Fed policy. Under a financial stability mandate, the Fed will need to replace its ideological convictions with common sense. When investors buy assets in anticipation of future price increases, the Fed will need to err on the side of caution and presume that a bubble is forming that could threaten financial stability.

The new mandate would also encourage the Fed to deal with excesses by striking the right balance between deploying its policy interest rate and other tools. In times of asset-market froth, I favor the leaning-against-the-wind approach with regard to interest rates—pushing the Federal funds rate higher than a narrow CPI-inflation target might suggest. But there are other Fed tools that can be directed at financial excesses—margin requirements for equity lending as well as controls on the issuance of exotic mortgage instruments (zero-interest rate products come to mind). In addition, the Fed should not be bashful about using the bully pulpit of moral persuasion to warn against the impending dangers of asset and credit bubbles.

Of equal importance is the need for the Fed to develop a clearer understanding of the linkage between financial stability and the open-ended explosion of derivatives and structured products. Over the past decade, an ideologically driven Fed failed to make the distinction between financial engineering and innovation. It understood neither the products nor their scale, even as the notional value of global derivatives hit \$516,000bn in mid-2007 on the eve of the subprime crisis—up 2.3 times over the preceding three years to a level that was 10 times the size of world GDP. The view in U.S. central banking circles was that an innovations-based explosion of new financial instruments was a huge plus for market efficiency. Unfortunately, that view turned out to be dead wrong.

Driven by its ideological convictions, the Fed flew blind on the derivatives front. On the one hand, this was hardly surprising because these are largely private, over-the-counter transactions. What is surprising is that the authorities failed to develop metrics that would have helped them understand the breadth, depth, and complexity of the derivatives explosion. This trust in ideology over objective metrics was a fatal mistake. Like all crises, this one is a wake-up call. The Fed made policy blunders of historic proportions that must be avoided in the future. Adding financial stability to its mandate is vital to preventing such errors again.

An Early Leadership Opportunity for Barack Obama

November 6, 2008

For President-elect Barack Obama, the campaign mantra of “change and hope” will meet a very quick reality test. Courtesy of a wrenching economic and financial crisis, his leadership skills could, in fact, be tested even before he assumes office. Not only would it be appropriate for him to weigh in on the mid-November 2008 G-20 summit in Washington, but his views could well be decisive in shaping the post-election efforts of the U.S. Congress to craft another economic stimulus package. In these troubled times, the new leader of the free world can hardly afford to remain silent.

Leadership and national image building go hand in hand. If he rises quickly to the occasion, President-elect Obama will be off to an excellent start in recasting America’s image to the world. Three principles should guide him in this urgent task.

First, his core strategy should be to foster a long overdue rebalancing of the U.S. economy. A dysfunctional growth model must be guided away from the asset- and debt-dependent consumption binge of the past dozen years toward a significant increase in long depressed domestic saving. Only then can the United States achieve a sustained reduction of its massive current account deficit, necessary to fund sorely needed investments in infrastructure and human capital.

Second, Barack Obama needs to move quickly in restoring America’s commitment to globalization. That means repudiating the politically inspired scapegoating of China and other saber rattling on the trade front. To do that, the president-elect needs to tackle a daunting middle-class

real-wage stagnation problem—the source of economic anxiety that has been the political foil for Washington’s increasingly worrisome protectionist tilt.

Third, the newly elected president must provide leadership to the regulatory reform of America’s bruised and battered financial system. There is a very real risk in today’s highly charged political climate that a regulatory backlash could go too far and end up impeding the efficiency of America’s market-based system of capital allocation. Reregulation must be even-handed, aimed not only at Wall Street but also at the rating agencies, a bubble-prone Federal Reserve, and other regulatory authorities.

If President-elect Obama can push early for a principled and judicious approach to financial sector reforms, there is good reason to hope that the new system will be a major improvement from the old one, ushering in an era of transparency, improved disclosure, better underwriting standards, and enhanced oversight. America’s financial markets and institutions would then be grounded in a new sense of discipline, accountability, and stability, capable of providing just the anchor that an all too unstable and reckless world sorely needs.

If Barack Obama can demonstrate early leadership in these three areas—saving, trade, and financial reform—the U.S. and global economy will be in much better shape than it is today, and the United States of America will have taken a giant step in reshaping its image in an increasingly troubled world.

Dying of Consumption

November 28, 2008

It's game over for the American consumer. Inflation-adjusted personal consumption expenditures are on track for rare back-to-back quarterly declines in the second half of 2008 at nearly a 4 percent average annual rate. There are only four other instances since 1950 when real consumer demand has fallen for two quarters in a row. This is the first occasion when declines in both quarters will have exceeded 3 percent. The current consumption plunge is without precedent in the modern era.

The good news is that lines should be short for today's first shopping day of the 2008 holiday season. The bad news is more daunting: rising unemployment, weakening incomes, falling home values, a declining stock market, record household debt, and a horrific credit crunch. But there is a deeper, potentially positive, meaning to all this: Consumers are now abandoning the asset-dependent spending and saving strategies they embraced during the bubbles of the past dozen years and moving back to more prudent income-based lifestyles.

This is a painful but necessary adjustment. Since the mid-1990s, vigorous growth in American consumption has consistently outstripped sub-par gains in household income. This led to a steady decline in personal saving. As a share of disposable income, the personal saving rate fell from 5.7 percent in early 1995 to nearly zero from 2005 to 2007.

In the days of frothy asset markets, American consumers had no compunction about squandering their savings and spending beyond their incomes. Appreciation of assets—equity portfolios and, especially, homes—was widely thought to be more than sufficient to make up the difference. But with most asset bubbles bursting, America's 77 million baby boomers are suddenly facing a savings-short retirement.

Worse, millions of home owners used their residences as collateral to take out home equity loans. According to Federal Reserve calculations,

net equity extractions from U.S. homes rose from about 3 percent of disposable personal income in 2000 to nearly 9 percent in 2006. This newfound source of purchasing power was a key prop to the American consumption binge.

As a result, household debt hit a record 133 percent of disposable personal income by the end of 2007—an enormous leap from average debt loads of 90 percent just a decade earlier.

In an era of open-ended house price appreciation and extremely cheap credit, few doubted the wisdom of borrowing against one's home. But in today's climate of falling home prices, frozen credit markets, mounting layoffs and weakening incomes, that approach has backfired. It should hardly be surprising that consumption has faltered so sharply.

A decade of excess consumption pushed consumer spending in the United States up to 72 percent of gross domestic product in 2007, a record for any large economy in the modern history of the world. With such a huge portion of the economy now shrinking, a deep and protracted recession is inevitable. Consumption growth, which averaged close to 4 percent annually over the past 14 years, could slow into the 1 percent to 2 percent range for the next three to five years.

The United States needs a very different set of policies to cope with its postbubble economy. It would be a serious mistake to enact tax cuts aimed at increasing already excessive consumption. Americans need to save. They don't need another flat-screen TV made in China.

The Obama administration needs to encourage the sort of saving that will put consumers on sounder financial footing and free up resources that could be directed at long overdue investments in transportation infrastructure, alternative energy, technologies, education, worker training, and the like. This strategy would not only create jobs but would also cut America's dependence on foreign saving and imports. That would help reduce the current account deficit and the heavy foreign borrowing such an imbalance entails.

We don't need to reinvent the wheel to come up with effective saving policies. The money has to come out of Americans' paychecks. This can be either incentive driven—expanded 401(k) and IRA programs—or mandatory, like increased Social Security contributions. As long as the economy stays in recession, any tax increases associated with mandatory saving initiatives should be off the table. (When times improve, however, that may be worth reconsidering.)

Fiscal policy must also be aimed at providing income support for newly unemployed middle-class workers—particularly expanded

unemployment insurance and retraining programs. A critical distinction must be made between providing assistance for the innocent victims of recession and misplaced policies aimed at perpetuating an unsustainable consumption binge.

Crises are the ultimate in painful learning experiences. The United States cannot afford to squander this opportunity. Runaway consumption must now give way to a renewal of saving and investment. That's the best hope for economic recovery and for America's longer-term economic prosperity.

■ Uncomfortable Truths about Our World after the Bubble

December 3, 2008

The textbooks have little to say about postbubble economies. That makes the current prognosis all the more problematic. A profusion of asset bubbles has burst around the world—from property and credit to commodities and emerging market equities. That’s an especially rude awakening for a global economy that has become dependent on the very bubbles that are now imploding. It is as if the world has suddenly been turned inside out.

The American consumer is a case in point. Real personal consumption expenditures are on track for rare back-to-back quarterly declines in the second half of 2008, at close to a 4 percent average annual rate. Never before has there been such an extraordinary capitulation of the American consumer.

Similar extremes are evident elsewhere. Europe and Japan have joined the United States in the first synchronous G3 recession of the post-World War II era. Nor has the developing world been spared. While most big developing economies should avoid outright contractions in overall output, sharp deceleration is evident in China, India, and Russia. Hong Kong and Singapore—Asia’s two prosperous city states—are both in recession. Moreover, reminiscent of the Asian financial crisis of 1997–1998, the currencies of South Korea, Indonesia, and India are under severe pressure. As the commodity bubble implodes, a similar boom-bust pattern is unfolding in Australia, New Zealand, Canada, and the Middle East.

Crises invariably trigger finger-pointing. This one is no exception. Global observers have been quick to blame the United States, arguing

that it's all about the excesses of Wall Street and America's subprime fiasco. Some would take it even further and condemn the freewheeling model of market-based capitalism. Let the record show, however, that while the United States certainly made its fair share of mistakes, the rest of the world was more than happy to go along for the ride.

That's especially the case in Asia, where China and other producers upped the ante on their export-led impetus to economic growth. By 2007, the export share of Developing Asia's gross domestic product exceeded 45 percent—fully 10 percentage points higher than the share prevailing during the Asian financial crisis of the late 1990s. Moreover, the Chinese led the way in recycling a disproportionate share of their massive reservoir of foreign exchange reserves back into dollar-based assets. That kept their currency, the renminbi, highly competitive, as any export-led economy likes, but also prevented U.S. interest rates from rising, keeping the magic alive for bubble-dependent American consumers. In effect, the world's bubbles fed off each other.

Nor did anyone force the German Landesbanken and the Swiss universal banks to invest heavily in toxic assets. And the new mega-cities of the Gulf region—Dubai, Doha, Riyadh, and Abu Dhabi—owe their very existence to the oil bubble. Now all of these bubbles have burst, leaving a bubble-dependent world in the lurch.

A postbubble shakeout is likely to be the defining feature of the global economic outlook over the next few years. Three conclusions on the postbubble prognosis are most apparent:

One, do not analyze a postbubble recession as a normal business cycle. As economies that levered their asset bubbles to excess—especially the United States—come to grips with tough postbubble realities, a powerful deleveraging will ensue. That could prolong the duration of the downturn, as well as inhibit the vigor of the subsequent recovery.

Two, on the demand side of the global economy, focus on the American consumer—the biggest and most overextended consumer in the world. With personal saving rates still close to zero and debt loads remaining at all-time highs, U.S. consumption is heading for a Japanese-style multiyear adjustment. After 14 years of nearly 4 percent average growth in U.S. real consumer spending, gains could slow to 1 to 2 percent over the next three to five years. And no other consumer in the world is capable of stepping up and filling the void.

Three, on the supply side of the global economy, focus on China. Industrial production growth has been cut in half in China, rising at just

8 percent year-on-year in October 2008 following five years of average gains of about 16.5 percent. With the global economy in recession, this outcome should hardly come as a surprise for a Chinese economy that has seen its export share of total gross domestic product nearly double from about 20 percent to almost 40 percent over the past seven years. China is paying a steep price for its own imbalances, especially a lack of support from internal private consumption.

In short, look for a postbubble world to remain in recession throughout 2009, followed by an anemic recovery, at best, in 2010. In an era of globalization, we became intoxicated with what cross-border linkages were able to deliver on the upside of a boom. But as that boom went to excess and spawned a lethal globalization of asset bubbles, the inevitable bust now promises an exceedingly tough hangover.

A Postbubble Global Business Cycle

January 7, 2009

There will be no V-shaped recovery for a world economy that has just entered its most severe recession of the post-World War II era. While the worst of the global downturn may run its course by late 2009, the risk is that any rebound in 2010 will be anemic and fragile. After nearly 5 percent average annual growth in world GDP in the four-and-a-half years preceding the so-called subprime crisis, global growth seems likely to average only about 2 percent over the next three years—well below the 3.7 percent trend of the past 40 years.

At work is a powerful postbubble shakeout for an unbalanced global economy. Headwinds are likely to be especially stiff on the demand side, long dominated by an unsustainable U.S. consumer-spending binge. With a notable lack of dynamism from private consumption elsewhere in the world, the external demand underpinnings of export-led economies will be impaired. Commodity producers will also suffer collateral damage from a U.S.-led slowdown in global demand. In short, the movie of the past decade is about to run in reverse.

The retrenchment of the American consumer is likely to be the pivotal development for the global economic prognosis. Unfortunately, U.S. consumers have long been ripe for the fall. With vigorous consumption gains consistently outstripping a subpar pace of income generation over the past 14 years, savings-short, overly indebted households drew freely on the combination of property and credit bubbles to take consumer spending up to a record 72 percent of real GDP in late 2006 and early 2007. But now, with those twin bubbles having burst, U.S. consumption has fallen sharply at close to a 4 percent average annual rate in the second half of 2008. Although that's a record rate of decline for two consecutive

quarters, this adjustment has been sufficient to reduce the consumption share of real GDP by only one percentage point to a still excessive 71 percent.

In light of the extreme pressures still bearing down on U.S. consumers—not just record debt and low saving, but also wealth destruction to homes and 401K plans as well as income losses associated with sharply rising unemployment—there is good reason to believe that a consumer-led rebalancing of the U.S. economy has only just begun. That portends a further decline of the U.S. consumption share of GDP—possibly down to the 67 percent prebubble norm that prevailed in the final 25 years of the 20th century. To the extent such a mean reversion is likely—a reasonable deduction, in my view—that means only about 20 percent of the U.S. consumption adjustment has been completed.

That poses a major problem for the global economy. The United States remains the world's dominant consumer. While America accounts for only about 4.5 percent of the world's total population, its consumers spent about \$9.7 trillion in 2007—almost five times the combined consumption of only about \$2 trillion coming from the nearly 40 percent of the world's population that lives in China and India. Nor do any of the world's other big consumers—notably those of Europe and Japan—have a growth dynamic on a par with the American consumer; private consumption growth in these two economies has been closer to 1 percent per annum over the past decade—less than one-third the pace of that in the United States. In short, prospects for a multiyear compression in U.S. consumer demand pose a major problem for an unbalanced global economy.

That's particularly true for export-led Developing Asia, the most rapidly growing region in the world. In 2007, the export share of Developing Asia's GDP hit a record high of 47 percent—up about 10 percentage points from the portion prevailing a decade earlier. By contrast, the private consumption portion of the region's GDP fell to a record low of 47 percent in 2007—down from close to 55 percent prevailing 10 years ago. Lacking an offset from internal consumer demand, Developing Asia is extremely vulnerable to an external demand shock. And that is exactly what is now unfolding. It's not just prospects for a multiyear weakening in U.S. consumer demand but also the onset of a rare synchronous G-3 recession—with simultaneous contractions in the United States, Europe, and Japan. Little wonder that every economy in export-led Developing Asia is now either slowing or already in recession. The hopes and dreams

of decoupling—an overly optimistic scenario that envisioned emerging market economies having the wherewithal to stand on their own in an otherwise weakening world—are in tatters.

All this underscores a striking asymmetry to the global rebalancing that is now unfolding. The excesses on the demand side are being tempered by a dramatic consolidation of the American consumer. Although this adjustment has just begun, the pressures are so severe that there is good reason to believe that U.S. consumption growth will remain quite weak for years to come. Conversely, there are few signs of a spontaneous acceleration in private consumption growth elsewhere in the world. Lacking in institutionalized safety nets—especially social security systems and pension regimes—consumers in developing economies remain predisposed more toward precautionary saving than discretionary spending.

That's especially the case for transitional economies such as China, where state-owned enterprise reforms have spawned massive job losses affecting over 60 million workers during the past 15 years. This has led to a heightened sense of employment and income insecurity—triggering a powerful outbreak of precautionary saving. As a result, the Chinese consumption share of GDP fell to a record low of nearly 35 percent in 2007, leaving China more dependent than ever before on exports and investment to maintain economic growth at a fast enough pace to prevent a serious increase in unemployment and social instability. Long the greatest beneficiary of globalization, an unbalanced Chinese economy stands much to lose in the face of a massive external demand shock.

The asymmetries of global rebalancing could well be decisive in shaping the contour of any recovery in the global economy. As always, it will take a vigorous rebound in consumer demand to spark a classic V-shaped upturn. Notwithstanding Washington's massive policy stimulus, the over-extended American consumer is not about to deliver that spark. Without a new global consumer, any recovery in the world economy is likely to remain disappointingly weak.

America's Japan Syndrome

January 13, 2009

No one in his or her right mind thinks that the United States could fall victim to a Japanese-like lost decade. After all, goes the argument, even if there were similarities between prebubble conditions in both economies, U.S. policy makers have the advantage in knowing what their counterparts in Japan did wrong. Out of those lessons comes a game plan that is widely presumed to prevent America from falling into a Japanese-style quagmire.

If it were only that simple! For starters, the parallels between the crises in Japan and the U.S. are striking. Both economies suffered from the bursting of two major bubbles—property and equity in the case of Japan and property and credit in the United States. Both had broken financial systems stemming from egregious risk management blunders. Both were victimized by a reckless lack of oversight—regulatory failures, misdirected rating agencies, and central banks that ignored asset bubbles. The *coup de grâce* was the lethal macro impacts of the twin bubbles on the real side of both economies—the corporate sector in the case of Japan and the consumer sector in the United States.

So much for history. How relevant are Japan-U.S. comparisons in gauging the future? Can America's policy makers avoid the postbubble pitfalls that left Japan mired in a decade of stagnation and deflation?

Those in charge in the United States—especially the Federal Reserve—believe that America is different, possessing both the wisdom and the conviction to avoid Japanese-like outcome. The Fed laid the groundwork for this assertion back in 2002, when the United States was reeling from the dot-com-induced bursting of the equity bubble. A landmark paper co-authored by 13 Fed staff economists concluded that the speed and vigor of the monetary policy response were key in avoiding a

replay of the Japan syndrome.³ The Bank of Japan, they argued, was too slow to grasp the enormity of postbubble risks. It follows, in this view, that a quicker and bolder policy reaction would have made a critical difference.

And so the script was written for America's central bank: Bubbles come and go—not much you can do about that, the Fed has long maintained. However, if the monetary authority is speedy in riding to the rescue of a postbubble economy, a Japanese style trap can be avoided. This approach appeared to pass an important reality check in the aftermath of the bursting of the U.S. equity bubble in 2000. The Fed was quick to slash the federal funds rate by 550 basis points to 1 percent and the U.S. economy eventually recovered. Alan Greenspan, in a celebrated mission-accomplished speech, boasted that “. . . our strategy of addressing the bubble's consequences rather than the bubble itself has been successful . . .”⁴

That experience gave the Federal Reserve license to prescribe the same medicine to subsequent postbubble shakeouts. Unfortunately, those tactics backfired. There is good reason to believe that the Fed's clean-up campaign after the bursting of the equity bubble in 2000 was, in fact, a one-off success—it provided a short-term fix at the cost of creating a long-term disaster. By following the anti-Japan script and pushing the policy rate down to rock-bottom levels and holding it there, the Fed ended up inflating the biggest bubbles of them all—property and credit.

Fear not, claim the optimists. America has been much quicker than Japan to write down bad loans, inject new capital into its banks, embrace a large fiscal stimulus, and adopt the so-called quantitative easing tactics of monetary policy. Noble as these efforts are, they may not be enough. That's because they do not arrest the most powerful force at work in the postbubble U.S. economy: Excess consumption now has to be tempered no matter what. The overextended, savings-short, asset-dependent American consumer has only just begun what appears to be a multiyear retrenchment. That means the authorities in Japan and the United States may have something else in common—limited policy traction and the related frustration of pushing on that proverbial string.

All this raises the distinct possibility that the U.S. central bank may have drawn the wrong lessons from Japan's lost decade. The correct

3. See Alan Ahearne, et. al., “Preventing Deflation: Lessons from Japan's Experience in the 1990s,” Federal Reserve International Financial Discussion Paper 729, June 2002.

4. See Alan Greenspan, “Risk and Uncertainty in Monetary Policy,” January 3, 2004.

policy prescription may have less to do with the speed and scope of postbubble clean-up tactics and more to do with avoiding major asset bubbles in the first place. Just as the Bank of Japan failed on that score, so, too, did the Fed. The new and critically important lesson: Central banks can no longer afford to address asset bubbles after the fact.

Yet there is an ominous distinction between the United States and Japan—the impacts of bubbles on their respective real economies. At more than 70 percent of U.S. GDP, the bubble-infected American consumer actually poses a much greater risk to today's U.S. economy than that imparted by Japan's bubble-induced capital-spending boom, which accounted for only about 17 percent of Japanese GDP at its peak in the late 1980s. Moreover, since the U.S. consumer is, by far, the biggest and, up until recently, the most dynamic of the large consumers in the world, the global implications of America's postbubble shakeout are likely to be far more severe than those imparted by Japan.

So what can the United States do to avoid becoming another Japan? Quite frankly, not much. In many critical respects, the die is already cast. By focusing on investments in infrastructure, alternative energy technologies, and human capital, the Obama Administration is correct in attempting to contain the recession and initiate a long overdue rebalancing of the U.S. economy. However, these actions will not cure the postbubble hangover of the overextended consumer. Most of all, that will take time but it will also require income support for the innocent victims of recession and a new prosaving mentality that encourages American families to live within their means.

Like Japan of the 1990s, the United States faces stiff headwinds for the foreseeable future. And until the rest of the world uncovers a new consumer—not a likely outcome during the next few years—a protracted global slowdown is a distinct possibility.

Whither Capitalism?

February 23, 2009

Rare is the crisis that doesn't shake fundamental beliefs and values. And the world's most wrenching financial crisis in 75 years has certainly done all that and more. Significantly, it has prompted many to question that most cherished of institutions, market-based capitalism. With governments around the world intervening on a seemingly massive scale, those concerns are hardly groundless.

In one sense, this is nothing new. The history of capitalism is very much a continuum of tough tests. Financial panics, periodic recessions, and even the Great Depression are all part of the stress testing that has long shaped the rough and tumble evolution of market-based capitalism. The core premise of capitalism rests on the simple notion that free markets and the free-enterprise system they promote are the optimal and most efficient means by which any society can allocate its scarce resources of labor, capital, and land. The magic of capitalism is the manner by which this allocation occurs—tasks that are ultimately executed by the “invisible hand” of Adam Smith.

That's not to say capitalism doesn't allow the State to play an important role in providing public goods like defense, internal protection, retirement security, and certain utilities such as water, transportation networks, and power. Yet private enterprise is the lifeblood of the capitalist model of income generation, wealth creation, and sustained economic growth. The enduring successes of the United States stand in sharp contrast to the failure of the central planning approach of the former Soviet Union. The stunning record of Chinese economic development is an explicit endorsement of capitalism—a development model that hinges critically on the ownership transition from state-owned enterprises to privately held companies.

But now the U.S. economy—the poster child of capitalism—is in the midst of its most wrenching financial crisis and recession since the 1930s. Many of the once-proud icons of Corporate America stand at the brink of failure and collapse. The full force of U.S. government policy is being directed at arresting this potentially lethal implosion. Under the too-big-to-fail doctrine, the lessons of the Great Depression have been central in framing a massive campaign of state-directed intervention into critical segments of once sacrosanct private industries and markets.

Such emergency government investments in privately held companies—capital injections as well as backstop financing—have become an all-too-frequent outgrowth of what started out as a mere subprime crisis. At the same time, compensation caps, home mortgage foreclosure mitigation efforts, and politically engineered consumer lending programs all smack of a quasi-socialization of American finance. Add to that, Washington's newfound aggression on trade policy—“buy America” government procurement policies, along with Chinese currency bashing—and it seems as if the U.S. strain of capitalism is being turned inside out.

Bailouts in Context

Notwithstanding the claims of a sensationalist media, the scale of state-directed intervention in America's privately held corporations remains relatively small. That shows up under careful examination of the two industries that have been the focus of such efforts—finance and autos. According to U.S. Commerce Department statistics, the value added by banks, securities firms, and other financial intermediaries collectively accounted for 6.2 percent of the private sector's GDP in 2007; the insurance sector made up another 2.8 percent, whereas the share going to motor vehicles manufacturers was just 0.8 percent. Private employment shares of these newly protected industries are even smaller—5.3 percent for finance and insurance and just 0.7 percent for motor vehicles.

To be sure, recent government interventions have been targeted at a subset of specific companies within these industries rather than at the entire industry, itself; for example, capital injections under the so-called TARP (Troubled-Asset Relief Program) framework were initially directed at just nine financial institutions whereas emergency bridge financing was extended to two of Detroit's Big Three. Clearly, there are

important behavioral spillovers between companies that have been direct recipients of government funds and those that have not received such assistance but are wary that they could be next. Combining the direct and indirect effects in these two industries provides an outside estimate of the U.S. government's recent "intervention share" of around 6 to 10 percent in the private economy.

That means, of course, that more than 90 percent of the private sector in the United States is still operating largely as a free-enterprise system. That is not exactly consistent with the widely popularized image of a "bail-out nation" that has been offered up to depict a U.S. economy in chaos and a market-based system on the brink of collapse.

Postcrisis Endgame

I would be the first to concede that for a crisis of the severity that is currently under way it is certainly possible that the government's recent interventionist actions could end up being only the first of many such efforts to come. Should recent actions beget more interventions in the future, the current angst over the crisis of capitalism would only grow.

Two key concerns are relevant in assessing such a possibility—that the need for intervention will spread and that the emergency palliatives of temporary support will eventually become permanent. The first concern depends critically on the depth and duration of the current U.S. recession. In my view, the main factor that will shape this outcome will be the coming adjustments of the bubble-dependent American consumer—currently still more than 70 percent of the U.S. economy. As the consumer goes, so goes the endgame of this most extraordinary business cycle.

Recent trends are hardly encouraging in this regard. Real consumption fell by nearly 4 percent (at an annual rate) in both of the final two quarters of 2008—the steepest back-to-back declines of the post-World War II era. If the retrenchment of U.S. consumption continues at such an unprecedentedly rapid pace, then an increasingly deeper recession is a distinct possibility—an outcome that could trigger considerably more distress in private sector businesses and concomitant efforts by the government to avoid failures in an increasingly broader swath of U.S. industry. I don't think it is a coincidence that Washington-directed interventions accelerated dramatically in the final three-and-a-half months of 2008—when a veritable implosion of the financial system led to a precipitous

deterioration in business and consumer sentiment. Should that firestorm persist, fears over the crisis of capitalism will only deepen.

Despite my long-standing concerns over the prospects for postbubble U.S. consumption, I do not believe such a macrocollapse scenario is the most likely outcome. While I expect that a good deal more consolidation lies ahead for the American consumer, an historical stickiness of U.S. consumption habits argues for a more gradual—albeit prolonged—normalization of consumer demand. Moreover, to the extent Washington's recently enacted \$787 billion fiscal stimulus package limits the contraction in aggregate demand and puts a floor on the depth of this recession, there is reason to be encouraged that the retrenchment of the American consumer will proceed at a less disruptive pace than was the case in late 2008. Time will obviously tell, but if that prognosis turns out to be correct, a sharp increase in the scope of interventions and bailouts is less likely than otherwise might be the case.

The second concern—that of the exit strategy from the recent sharp step-up in U.S. government support—is more problematic. The debate over fiscal policy is now being framed in the context of an era of trillion dollar budget deficits rather than in a climate in need of a temporary fiscal stimulus. President Obama's recent emphasis on the eventual restoration of a postcrisis fiscal discipline is encouraging, but this could well be his toughest political battle on economic policy. At the same time, the Federal Reserve now speaks of an enduring regime of extraordinary monetary accommodation and liquidity injections into dysfunctional markets and beleaguered financial institutions. In short, it's hard to have much confidence in the case for a prompt postcrisis normalization of U.S. fiscal and monetary policies, especially since the authorities have no experience whatsoever in pulling off such a Great Escape.

An increasingly intractable exit strategy is, unfortunately, the rule and not the exception for relapse-prone economies that have suffered from the bursting of major asset and credit bubbles. As Japan's experience shows with painful clarity, once a postbubble economy needs to go on the life-support of extraordinary fiscal and monetary stimulus, it is extremely difficult to wean the chronically ill patient from this medicine. Nearly 20 years after the bursting of the Japanese equity bubble, the nation's public-sector debt stands at 148 percent of GDP; moreover, the Bank of Japan is now celebrating the tenth anniversary of its zero-interest rate policy. The same can be said of halfway measures on the road to nationalization for insolvent industries. The longer the ultimate solution is avoided for

zombie-like companies, the more elusive the postbubble exit strategy and the more dependent a weakened business sector becomes on ongoing government intervention and support. All in all, as long as a decisive and transparent exit strategy from the policies of crisis containment is lacking, there is good reason to suspect that the debate over the efficacy of market-based capitalism will continue.

Shared Responsibility

In the end, the true test of capitalism will most likely come from its ideological roots—in particular, from the ability of the body politic to endure the often-harsh verdict of free markets and their all too frequent penchant for creative destruction. In crisis and recession, the tolerance for such pain is invariably subjected to its sternest test—a trial under duress that often turns into a destructive blame game. The search for scapegoats can become an obsession—in effect, a lightning rod for national angst. But scapegoating can play an even more destructive role—it can bias and eventually undermine the reregulatory fix that invariably follows any crisis.

Therein lies one of the greatest potential pitfalls in the postcrisis backlash of 2009. Wall Street has been singled out as the villain in this crisis. On one level, this is understandable. Financial service firms did make many serious and regretful mistakes—from faulty risk management models and perverse incentive systems to misguided business strategies and momentum-driven capital deployment. But they were hardly alone. The modern U.S. financial system has long been under the purview of an institutionalized network of checks and balances, controlled by regulators, a politically independent central bank, and congressional oversight. Rating agencies were empowered as the arbiters of risk assessment. Yet every single one of those safeguards failed to temper the systemic problems that were building for years in the Era of Excess. The question is, why?

The answer is not particularly pleasant—it goes to the heart of a greed-driven capitalism. Booms—artificial or real—distort incentives. Booms also warp values and blind the United States to downside risks. And denial—that most powerful of human defenses—leads the United States to dismiss the tough questions that might draw the staying power of a boom into question. In this boom, there was everything to gain from keeping the magic alive and much to lose by drawing it all into question. In short, the American body politic—from Wall Street to Main Street to Washington—was consumed by the hopes and dreams of the boom and

desperate for the good times to continue. And so, by the way, was the rest of the world—especially export-led developing economies whose new-found prosperity was built on selling anything and everything to overextended American consumers. Literally, no one wanted this party to end.

But now the party is over—and painfully so for a world in recession and for markets in chaos. The task ahead is to pick up the pieces, learn the lessons of this crisis, and take actions to ensure these types of problems never occur again. The postcrisis fix can succeed only if it is grounded in the premise of shared responsibility. A targeted politicized fix is not a solution to a systemic problem. Fix the system that gave rise to the crisis—not just the banks that have defined ground zero of a wrenching credit crunch. The piecemeal prescription of the blame game virtually guarantees there will be a next time—an even bigger crisis that deals an even tougher blow to market-based capitalism.

Rethinking Governance

The dangers of a politically driven postcrisis vendetta cannot be minimized. The current mess is deeply rooted in an ideological approach to economic governance—namely, America's libertarian penchant for self-regulation. Alan Greenspan, the high priest of this approach, framed most of the Federal Reserve's critical policy choices in the context of this ideology. As seen through this lens, asset bubbles were not judged to represent a dangerous build-up of speculative excesses—instead, they were repeatedly perceived as outgrowths of America's thriving free enterprise system. The equity bubble of the late 1990s was justified by the breathtaking acclaim accorded to IT-enabled productivity-led advances of a New Economy. Property bubbles were presumed to be local, not national—especially in an era of rising home ownership at the lower (or subprime) end of the income distribution. And the credit bubble, together with the risk bubble it spawned, was offered as testament to the genius of financial innovation and American creativity. Market libertarians simply looked the other way as the United States lurched recklessly from bubble to bubble.

Bubbles, of course, are always based on a shred of truth. But the post-bubble wreckage of the U.S. economy begs for a very different interpretation than the one that became conventional wisdom over the past decade. So, too, does the Fed's blatant abrogation of its regulatory responsibilities during the Greenspan years. Nowhere was that more apparent

than in the central bank's failure to make the distinction between financial engineering and financial innovation. Far from playing the widely popularized role as the ultimate shock absorber, the "originate and distribute" hallmark of the derivatives explosion became a lethal transmission mechanism of cross-border and cross-product shocks. Ideology blinded America's central bank, as well as its political overseers, to the imperatives of discipline—and let an unregulated and increasingly unstable free-enterprise system veer unnecessarily out of control.

Over time, I suspect that this crisis will be seen more as a failure of governance rather than as an inherent flaw in the free-market system, itself. The postcrisis fix will, indeed, turn Wall Street inside out. But the new regime must also include a revamped code of governance—not just regulatory streamlining and reform but also the hardwiring of financial stability into the policy mandates of central banks. Independent central banks that operate apolitically and free of ideology could well be the most important stewards of a postcrisis capitalism. But they can't do it alone. Only through better discipline and more effective governance of regulators, rating agencies, and the political oversight function, can the invisible hand start to work its magic once again.

Capitalism has come a long way since Adam Smith wrote *The Wealth of Nations* more than 230 years ago. Markets and the instruments they trade have become exceedingly complex and interrelated. Today's globalized world is tightly linked through cross-border flows in trade, financial capital, labor, and information. The risks of this new connectivity have been amplified by increasingly complex financial instruments. At the same time, the pendulum of political ideology and control swung toward market libertarianism and self-regulation. In the end, this was an extremely dangerous combination—it allowed complexity to morph into instability. Self-regulation of an unstable system was a disaster waiting to happen. We are living today in the midst of just such a disaster—a crisis of epic proportions.

Yet the demise of capitalism is greatly exaggerated. As the free-enterprise system survived the Great Depression of the 1930s, I have little doubt it will reinvent itself and endure the current crisis. We can and must do much better in making market-based capitalism a safer, more stable, and sustainable system. There has been a major systemic failure of the model that has held the world together since the 1930s. Governance, or the lack thereof—both within the private sector as well as by those charged with regulation and oversight—proved to be the weak link in the chain. Fix that, and capitalism will be just fine.

After the Era of Excess

March 5, 2009

The world stopped in 2008—and it was a full stop for the era of excess. Belatedly, the authorities have been extraordinarily aggressive in coming to the rescue of a system in crisis. But as in the case of Humpty Dumpty, they will not be able to put all the pieces back together again. The next era will be very different from the one we have just left behind.

In large part, that is because this is a profoundly different crisis. It stands in sharp contrast to earlier disruptions, such as the Latin debt crisis of the 1980s, the Asian financial crisis of 1997–1998, or the bursting of the dot-com bubble at the turn of the century. In those instances, the pressures were confined largely to a region or an asset class, while the rest of the world benefited from insulation and resilience. This time, there is no place to hide. An unbalanced and interconnected world is now in the midst of a painful but necessary rebalancing.

Steeped in denial during the days of froth, policy makers, financial markets, the business community, and Main Street all reached the same erroneous conclusion—that an increasingly sophisticated and globalized world had learned to live with its imbalances. Some called this the Bretton Woods II era, cemented by a new symbiotic relationship between China (the saver and producer) and America (the borrower and consumer). Under this arrangement, most observers came to believe, unprecedented saving and current-account disparities could be finessed indefinitely, as could record debt burdens and currency misalignments. Someday, went the argument, the world would have to face up to its imbalances, but the day of reckoning was always assumed to be in some far-off, distant future. That was the fatal mistake made by a world in denial. The day of rebalancing is now at hand.

The implosion of 2008 was very much an outgrowth of the unique character of the world's imbalances, which visibly manifested themselves in a succession of ever-larger asset bubbles. The United States lies at the root of this phenomenon. Starting with the dot-com bubble of the late 1990s, the country went down a path littered by a succession of asset bubbles—from equities to property to credit. Bubbles are bad enough in and of themselves. They become all the more treacherous when they infect the real economy. That, indeed, was the most dangerous and destabilizing aspect of the era of excess (see Figure 1.4 on page 80).

In the end, the U.S. consumer was engulfed by the biggest bubble of them all. United States consumption reached an astonishing 72 percent of GDP in 2007, a record for the United States and, for that matter, any major economy in modern history. This consumption spike was fully five percentage points above the 67 percent share that prevailed for 25 years in the prebubble era, from 1975 to 2000. Significantly, the consumption binge was not supported by the economy's internal income-generating capacity; labor compensation—the income forthcoming from current production—fell in late 2008 to a level of more than \$800 billion (in real terms) below the trajectory of previous cycles.

Instead, America's consumption binge drew support from two major asset bubbles—property and credit. Courtesy of cheap and freely available credit, in conjunction with record housing price appreciation, consumers tripled the rate of net equity extraction from their homes, from 3 percent of disposable personal income in 2001 to 9 percent in 2006. Only by leveraging increasingly overvalued homes could Americans go on the biggest consumption binge in modern history. And now those twin bubbles—property and credit—have burst, and so has the U.S. consumption bubble: Real consumer spending fell at nearly an unprecedented 4 percent average annual rate in the two final quarters of 2008.

While the original excesses were made in America, the rest of the world was delighted to go along for the ride. With the United States lacking in internal saving, it had to import surplus savings from abroad in order to grow—and ran massive current-account and trade deficits to attract that capital. This fit perfectly with the macroimbalances of the export-led developing countries of Asia, whose exports exceeded a record 45 percent of regional GDP in 2007—fully 10 percentage points higher than their share 10 years earlier, in the depths of the Asian financial crisis. China led the charge, taking its exports from 20 percent, to nearly

40 percent of its GDP over the past 7 years alone. The export-led growth in Developing Asia could well be described as a second-order bubble—in effect, a derivative of the one in U.S. consumption.

Sure, there are destinations for end-market demand other than the United States, an observation that mistakenly led many to believe that Asian exporters were insulated by an increasingly diversified mix of external demand. That was wishful thinking. Once again, China is an important case in point. Yes, the United States now accounts for only about 20 percent of total Chinese exports. Shipments to Europe and Japan collectively account for another 30 percent, while the bulk of the remainder shows up in the form of sharply growing intraregional Asian trade. But there is a serious problem with the notion that China or any other major economy has successfully weaned itself—or decoupled—from overreliance on U.S. markets. Whether it is Europe, Japan, or developing countries of Asia other than China, all have one critical characteristic in common: insufficient internal private consumption and an overreliance on exports as a major and increasing source of growth. Intraregional trade has expanded sharply in Developing Asia, but with internal consumption as a share of GDP continuing to fall, these economies remain hugely dependent on end-market demand in the developed world.

As a result, there can be no mistaking the bottom line of this global recession. When the world's dominant consumer—the United States—enjoys an extraordinary boom, so do the world's major exporters. But when the U.S. boom goes bust, export-led economies around the world are in serious trouble. That's precisely the nature of the adjustment now bearing down so acutely on Japan; Developing Asia; Germany; and America's NAFTA partners, Canada and Mexico. All of these export-led economies are either decelerating sharply or in outright recession.

There's an even more insidious aspect of a bubble-dependent world. The Chinese, of course, led the way in recycling a disproportionate share of their massive foreign-exchange reserves back into dollar-based assets. That kept China's currency highly competitive, as any export-led economy likes, but also prevented U.S. interest rates from rising—thereby keeping the magic alive for bubble-dependent U.S. consumers. In effect, the world's bubbles fed off each other.

That game is now over. With the U.S. consumer most likely in the early stages of a multiyear contraction, the postbubble world is likely to face stiff headwinds for years to come. In large part, that's because

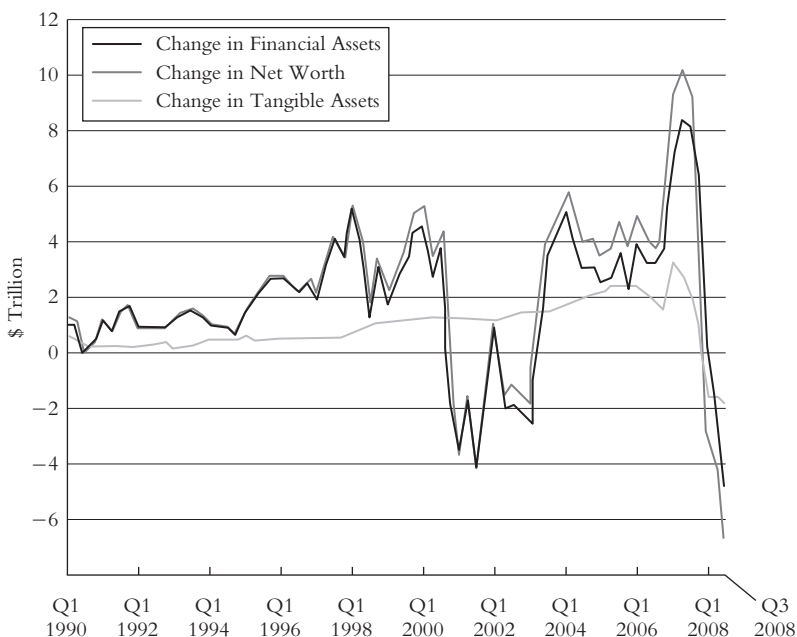


Figure 1.4 Change in U.S. Household Assets and Net Worth

Note: Data include nonprofit organizations.

Source: Haver Analytics, McKinsey Global Institute analysis.

there is no other consumer to fill the void. Sluggish growth in consumption has long been the norm in Europe and Japan. The same is the case for developing economies, where consumption is constrained by the imperatives of precautionary saving to compensate for the lack of safety nets such as social security, pensions, and medical and unemployment insurance. In China, the poster child for this problem, consumption as a share of GDP fell to a record low of around 35 percent in 2007—literally half the share in the United States. All in all, a postcrisis global economy is likely to struggle for years in the aftermath of America's consumption boom and in the absence of any dynamism from private consumption elsewhere. This paints a picture of an extremely tepid recovery from the current global recession.

The policy response to this crisis has been disturbing on one critical count: The global body politic is doing its best to resist rebalancing. Near-term tactics are all about containing the crisis, with little appreciation of The strategic implications of these actions. Here as well, America and

China are emblematic of the problem. In the United States, Washington has focused on measures that would sustain excess consumption through tax rebates and other types of income injections. There is also growing support for mortgage foreclosure relief—in effect, perpetuating uneconomic levels of home ownership by many people who simply cannot afford their still-overvalued dwellings. Meanwhile, in China, policy priorities remain focused on providing support for investment, through a massive \$585 billion infrastructure program, and on exports, through a shift in currency policy and tax rebates for exporters. By contrast, little is being done to stimulate the Chinese consumer.

Such actions suggest a world that has learned little from a wrenching global rebalancing—a world that believes the answer to recession and crisis is a return to the very same strain of unbalanced economic growth that got the United States into this mess in the first place. Yet in the end, that's the very last thing the world needs. America does not need to perpetuate its unsustainable consumption binge; it needs to save and recycle its savings into investments in infrastructure, alternative-energy technologies, and human capital. China does not need more hypergrowth led by investment and exports; it needs to shift the mix of its economy toward private consumption. Yet both nations seem unwilling, or unable, to make the tough choices that a more strategic policy response requires.

Sadly, this reactive approach reflects a global body politic that always seems to be focused on the quick fix. This time, that reaction has been amplified by the severity of the problem. It's as if the crisis is so threatening that short-term tactics must take precedence over long-term strategy, however noble it may be to promote the structural shifts required to rebalance an unbalanced world. This is where leadership could be decisive in shifting the debate—in having the courage to look beyond the valley.

None of this is to say, of course, that policies shouldn't be acutely sensitive to the plight of the innocent victims of recession and crisis. Unemployed workers need enhanced income support—especially unemployment insurance and retraining programs—and a dysfunctional financial system needs stopgap repairs. However, while the authorities need to backstop a system in acute distress, they must do more. The tactics of crisis containment cannot be the sole focus of the policy response to this wrenching global recession. The world also needs a strategy.

Benefiting from a decisive election victory, Barack Obama has an extraordinary opportunity to provide just that. Early indications pointing to a large public-works spending package—especially for infrastructure

and alternative-energy technologies—are very encouraging. But that begs the broader question: Does the rest of the world have the wisdom and the courage to shift the policy debate away from tactics and toward strategy?

This global crisis and recession have a deeper meaning: They give the United States and the rest of the world an opportunity to learn the tough lessons about what went wrong and how to avoid similar mistakes in the future. A failure to heed those lessons and to use the resulting insights in framing new policies would be the biggest tragedy of all.

Same Old, Same Old

March 10, 2009

A crisis-torn world is in no mood for the heavy lifting of global rebalancing. Policies are being framed with an aim toward recreating the very boom that has just gone bust. Washington wants to get credit flowing again to overly indebted American consumers. And exporters around the world—especially in Asia—would like nothing better than a renewal of external demand led by the world’s biggest consumer.

This is a recipe for disaster. That’s not to say the powerful fiscal and monetary medicine now being administered won’t temporarily alleviate the symptoms of a world in distress. But if these policies end up perpetuating the very imbalances that got the global economy into this mess in the first place, the inevitable next crisis will be even worse than this one.

Lest I be accused of fear mongering, it pays to replay the tapes of a decade ago. Then, the Asian financial crisis was widely viewed as the worst crisis since the Great Depression. As contagion spread from Asia to Russia, Brazil, and eventually a large U.S. hedge fund, the ensuing turmoil was dubbed the first crisis of modern globalization. Former Federal Reserve Chairman Alan Greenspan was stunned by what he dubbed an unprecedented “seizing up” of capital markets. Sound familiar?

As appropriate as those superlatives may have seemed in the late 1990s, they ended up depicting a minor squall when compared with the current tsunami. That’s just the point: Until an unbalanced world faces up to its chronic imbalances, successive crises are likely to be increasingly destabilizing. Although it’s hard to believe that anything could be worse than what’s happening today, I can assure you that same feeling was evident in late 1998.

Ironically, the seeds of the current crisis may well have been sown by policies aimed at arresting the Asian financial crisis. Back then, U.S.

authorities did everything they could to ensure that the crisis would not infect the real economy. The Fed's three emergency rate cuts in late 1998 worked like a charm—the U.S. consumer never looked back. The personal consumption share of real GDP soared from 67 percent in the late 1990s to a record 72 percent in the first half of 2007. America's antidote to the Asian financial crisis was the greatest consumption binge in modern history.

Bruised and battered Asia couldn't have asked for more. The binge-buying American consumer was Asia's manna from heaven. It reinforced the region's conviction in its export-led formula for economic development. Developing Asia was quick to up the ante on this approach, pushing the export share of its GDP from 36 percent in 1997–1998 to 47 percent by 2007.

But it didn't stop there. An increasingly integrated Asian economy also discovered the new synergies of a China-centric supply chain. Moreover, commodity producers around the world—especially, in Australia, Russia, Canada, and even Brazil—drew great sustenance from a resource-intensive, export-led Chinese economy.

And so it was in the aftermath of the Asian financial crisis. Imbalances became the rule, not the exception. Yet just as the United States was steeped in denial on the demand side of the global economy, a similar complacency was evident on the supply side. That was true of America's consumption binge—accompanied by record debt burdens, zero saving rates, and a multiplicity of bubbles in asset markets (equity and property) and credit. It was also true of Asia's export boom, which spawned ever-rising current account surpluses, enormous reservoirs of foreign exchange reserves, and a megabubble in commodity markets. Imbalances were a problem for another day. All that mattered back then was the postcrisis fix.

That's precisely the mindset today. To its credit, the Obama stimulus package is framed around the strategic imperatives of investing in infrastructure, alternative energy technologies, and human capital. But the Washington subtext is far more short term, focused mainly on increasingly urgent efforts to jump-start personal consumption. Toward that end, the Fed, the Treasury, and the Congress are all eager to restart borrowing for overextended consumers and prevent foreclosures of overly indebted home owners. The costs of inaction are billed as prohibitive. The U.S. body politic could care less about the debt implications of its stimulus actions.

In Asia, hopes are focused on the mirror image of this tale. The main questions Asians ask these days pertain to the state of the American consumer. Apparently, it's just too hard for Asian policymakers to establish robust social safety nets and stimulate internal private consumption. Unbalanced Asian economies are desperate for unbalanced American consumers to start spending again and spark another postcrisis recovery.

Grow now and ask questions later. That has once again become the mantra for an unbalanced world in crisis. Yet that's the biggest risk of all for global policy. The G-8 failed to embrace the imperatives of global rebalancing after the Asian financial crisis. And the G-20 seems destined to follow the same script at its upcoming summit in early April. What a reckless way to run the world.

Depression Foil

April 15, 2009

Debate rages over the endgame for the Great Recession. The broad consensus of policy makers, financial-market participants, business leaders, and academics concurs that the world is in the midst of its worst decline since the 1930s. In making that comparison, there is a presumption that another depression is a distinct possibility if immediate steps aren't taken to contain the downward spiral.

This debate misses the point—and dangerously so. Although I have been as bearish as anyone over the past several years, I would still assign a very low probability to a 1930s-style depression for the United States and the broader global economy. Monetary and fiscal authorities have made it quite clear that they are prepared to do everything in their power to avoid such an outcome. Ultimately, I suspect they will get their way.

Yet there is a serious and worrisome risk to this policy strategy. By fixating on the antidepression drill, authorities are failing to address the root cause of the current crisis and recession—the lethal unwinding of unsustainable global imbalances.

As one leading G-7 official put it to me recently, “In the short term, we need to get the world moving again. Then, over the medium term, we will tackle global imbalances.” This is the essence of the Depression Foil—a single-minded preoccupation with avoiding a 1930s-style collapse at all costs while putting off the requisite heavy lifting for that proverbial next day.

Unfortunately, the myopia of the political cycle preordains such a policy response. A resumption of economic growth is all that ever seems to matter for poll-driven politicians and their surrogate policy makers. Tough problems are always deferred with a vacuous promise to tackle them in due course. Then that due course always is pushed out further and further in time.

This is precisely the mindset that got the United States into this mess. I well remember the debate over America's current account deficit, one of the most glaring manifestations of an economy built on quicksand.

Some argued that there was nothing to worry about in a world that was now joined in a new "Bretton Woods II" paradigm, where a symbiotic relationship between the creditor (mainly China) and the debtor (the United States) would sustain this imbalance in perpetuity. There were others, such as Alan Greenspan, who worried about the long-term sustainability of America's external shortfall but stressed that such imbalances were likely to persist for much longer than most thought.

The problem with the apologists is that they failed to appreciate the deeper meaning of these imbalances. The U.S. current account deficit didn't emerge out of thin air. It was the outgrowth of an unprecedented shortfall of domestic saving. Saving itself was depressed by the bubble-driven illusions of an asset-dependent U.S. economy and especially by the willingness of consumers to live well beyond their means by extracting equity from overvalued homes.

In short, America's external imbalance was joined at the hip to the toxic interplay between asset and credit bubbles. Moreover, denial was global in scope. Export-led economies were delighted to draw support from bubble-dependent American consumers. And now, that house of cards has collapsed.

Unwittingly, the Depression Foil might well end up recreating this madness. With the risk of a depression viewed as completely unacceptable to the global body politic, the full force of the policy arsenal is being aimed at jump-starting aggregate demand, regardless to the consequences such results might imply for a new build-up of global imbalances.

Once again, the United States is leading the charge. The Fed wants to get credit flowing again to still overextended American consumers, especially in mortgage markets. The Congress wants to stop the bleeding in the housing market, regardless of the persistent imbalance between supply and demand. And the White House wants consumers to start spending again—to avoid the perceived pitfalls of the "paradox of thrift" brought about by too much saving.

Put it together and it all smacks of a dangerous sense of *déjà vu*: promoting a false recovery by kick-starting overextended, savings-short American consumers to borrow once again by leveraging their major asset.

Fortunately, the American consumer is smarter than the quick-fix Washington mindset. Shell-shocked families—especially some 77 million

baby boomers for whom retirement planning is an urgent imperative—know they have no choice other than to save. The personal saving rate has risen from around 1 percent in the fall of 2008 to more than 4 percent by March 2009, and is on its way to a new postbubble equilibrium that I would place in the 7.5 percent to 10 percent zone.

Yet policy makers fear such an outcome. It certainly doesn't fit the script of the Depression Foil. A persistently weak American consumer is viewed as a worrisome threat to another sickening down leg for a world in recession.

This is the essence of the macro disconnect that is now shaping post-crisis policies around the world: The global economy has become overly dependent on one consumer. Yet, like it or not, this source of growth will be severely impaired for years to come—a necessary and welcome rebalancing of the U.S. economy. However, this should not be viewed as a nail in the coffin for a Global Depression scenario.

A retrenchment by the American consumer should be viewed as a wake-up call for other nations to fill the void by stimulating their own consumers. A globalized world needs to move from one consumer to many.

The Depression Foil blinds policy makers and politicians to the imperatives of global rebalancing. This crisis and the wrenching recession it has spawned are all about a destabilizing shift in the mix of global saving and aggregate demand.

That mix needs to be redressed. The excess spenders need to save and the excess savers need to spend. Policies that encourage such rebalancing will put the world economy on a more stable and sustainable path and go a long way in avoiding another crisis like this in the future.

The Depression Foil makes it exceedingly difficult for an unbalanced world to get its act together. The G-20 summit in April 2009 was notable for its failure to address this critical challenge. Policy makers and politicians need to move beyond their depression fixation and aim at achieving better balance in the global economy before it is too late.