SEBASTIAN MALLABY, *THE WASHINGTON POST* AND
THE COUNCIL ON FOREIGN RELATIONS

# A Chastened World Economy

Recovery from the worldwide recession that began with the collapse of U.S. home prices in mid-2006 is likely to be slow, with long-term growth trending lower than in the past. Sebastian Mallaby, *Washington Post* columnist and director of the Maurice R. Greenberg Center for Geoeconomic Studies at the Council on Foreign Relations, identifies three structural obstacles to sustained economic recovery over the next five to ten years: replacing the U.S. consumer as the engine of global growth; instability of the U.S. dollar as the global reserve currency; and fixing financial regulation. Mallaby notes the serious difficulties of addressing these obstacles, which lead him to be very cautiously optimistic about the prospects for the global economy despite the positive signs of economic recovery evident in mid-2009, when he spoke at the Forum's Aspen Symposium. Mallaby discusses the geopolitical consequences of the financial crisis for the United States and highlights the massive accumulation of government debt as the U.S.'s fiscal Achilles heel. He believes that U.S. power depends upon the government's ability to borrow in a crisis, and describes a scenario wherein China sells its holdings of U.S. Treasuries in a deliberate effort to stimulate a financial crisis for the U.S., using the dollar as a weapon. The move would cost China as well; nevertheless, the U.S. is vulnerable to the Chinese government's vast holdings of U.S. dollars. Excerpts of Mallaby's remarks are reprinted here.

## CAUTIOUS OPTIMISM

We're hearing talk of green shoots, providing some grounds for *cautious* optimism about the prospects for the global economy—and it's not just talk; it's real. If you look at the oil index, the world equities index, and the measure of risk spread in the bond market, you can see that they're all headed nicely upwards. But I think emphasis really should be on "cautious." And that's partly because although there have been advances, they've been off an extraordinarily low base to start.

How low is this base? Despite the green shoots, it's a fact that on measures of U.S. real GDP growth, world trade, and equity market performance, we are still way at the bottom of anything experienced in the post-World War II era. And unemployment is worse than anything we've seen since World War II.

- Three key structural obstacles will dampen global economic recovery over the next five to ten years: replacing the U.S. consumer as the engine of global growth; instability of the U.S. dollar as the global reserve currency; and fixing financial regulation.
- U.S.-China dialogue is extremely important now because the extent to which the U.S. can encourage the Chinese government to build domestic safety nets—and thereby reduce savings and increase spending by the Chinese people—will have a huge effect on the health of the world economy in the medium term.
- At the moment, there is no attractive alternative to the U.S. dollar as the global reserve currency; however, the fact that the Chinese and others are looking for an alternative points toward instability in the future—including, possibly, a deliberately created dollar crisis.
- U.S. power depends upon the attractiveness of U.S. Treasuries and the government's ability to borrow in a crisis. The drop in credibility of the dollar as the U.S. budget deficit soars threatens future U.S. power.
- The economic progress of India, a democracy on a path toward free market reforms that shift that enormous country into the U.S. camp, greatly affects the long-run interests of the United States.

Another thing about this downturn is that there really has been nowhere to hide. A couple years ago, people were talking about the so-called decoupling of the world economy, this notion that the U.S. could sneeze and the rest of the world wouldn't necessarily catch a cold. Well, despite a lot of rather bold statements from President Lula in Brazil and European leaders to the effect that this is an American crisis, made in America, it did affect everybody. And it affected not just the financial sector, but all sectors of the economy: oil and gas, technology and so forth—even supposedly recession-proof areas like utilities have fallen in price substantially. So, beware the green shoots. There could be more shoes to drop in the financial system, as well as the possibility that more falls in house prices will cause more defaults on mortgages. There's also the feeling that commercial real estate could go sour and hasn't fully emerged yet as a problem.

It's worth noting that some of these positive signals can also have a delaying effect on the recovery. So it's great, for example, that oil prices are coming up because that seems to suggest that the demand for oil is going up and industrial production is rising. But of course, higher oil prices are going to dent people's wallets and reduce the consumption they can afford, among other things.

All of the literature on past recessions shows that there are two sorts of recession that tend to be more durable than others: The first kind of recession that lasts a long time is the recession that begins not with the Fed raising interest rates to force out inflation (a sort of business cycle correction) but, rather, a recession that is driven by a financial crisis, which always takes much longer to recover from because a financial crisis wipes out people's wealth. And it takes a while to rebuild the wealth for individuals to feel ready to spend again.

The second kind of downturn that takes a long time to recover from is an internationally synchronized one because if you're down while the rest of the world is fine, you can export your way out of the crisis. But when everybody's suffering, it's difficult for everyone to have an increase in their exports.

The current downturn meets both of these tests. In other words, it's both financially driven and internationally synchronized—and that means that recovery is likely to be slower, not faster.

So that's a little bit of context. I want to make two main points in the rest of the talk. The first is that we should remember that the structural obstacles to a sustained recovery in the medium-term are serious. There are three types of obstacles to sustained recovery, and it's difficult to be optimistic that the world is going to solve any of them, which is why I'm a bit dubious about a quick return to growth.

The second thing I want to do is try to weave into this discussion some of the geopolitical consequences of the financial crisis. I run the Center for Geoeconomic Studies at the Council on Foreign Relations, which looks at the intersection between international economics on the one hand and international relations on the other, because the real world is not stove-piped and so we try not to stovepipe our thinking.

## STRUCTURAL OBSTACLES TO SUSTAINED RECOVERY

### *Replacing the U.S. Consumer*

U.S. consumers lost upwards of $13 trillion in household wealth in 2008, about 20% of their total wealth. When you lose a fifth of your wealth, you have to rebuild savings. It's possible that people will overshoot that for a while because they've had such a hit to their finances that they have to save even more to get back to the place where they feel comfortable about their retirement prospects, college education for their kids, and so forth. The world economy is experiencing a shock from the absence of the U.S. consumer as the engine of global growth.

Who will replace the U.S. consumer? For now, the answer is that the U.S. government is the consumer of last resort, which is why we have the biggest fiscal deficit since 1945. Back in December 2007, George Bush was criticized—rightly, in my view—for being too lax fiscally. But the deficit was 1.3 percent of GDP. Well, we're up to 11.9 percent forecast this year and it's an absolutely astronomical increase in debt. We basically have World War II without the war, in fiscal terms. The increase in the deficit is way out of the postwar experience—much, much more dramatic than anything since 1945. So we've got this 12 percent of GDP fiscal deficit. The U.S. consumer is being replaced by the U.S. government. That can't possibly last: 12 percent of GDP deficit.

What level of deficit is sustainable? Well, if our economy grows around 2 percent a year and we increase our national debt by 2 percent a year, the national debt-to-GDP ratio would be constant. So, 2 percent of GDP would be a guideline for a commonsense, sustainable level of deficit. Bringing it down from 12 percent to 2 percent takes 10 percentage points out of net government spending. And that is more than a trillion dollars—a massive hit to the world economy, a reduction in financial demand possibly even more dramatic than that from the U.S. consumer. I'm just talking about the U.S. here, but of course you can tell some of this same story about other rich economies, which have also suffered massive fiscal hits.

If the U.S. consumer is strained, if the U.S. government cannot sustainably replace the U.S. consumer as the big spender in the world economy, who will replace it? Well, the three economies that have a lot of savings, and therefore

ability to spend more, are China, Japan and Germany. What are the prospects that any of these three will step forward and consume more and replace the departing U.S. consumer?

Well, German politicians make no bones about this. They like their export-driven model. Angela Merkel has said so clearly: we like this model; we want to keep it; we don't want to change; forget it if you think we're going to change. I think we can't be too optimistic, given the German political climate and the political debate there, that Germany is going to step forward and provide the world with extra demand.

What about Japan? Well, actually, the Japanese government does talk about stability and the need for stimulus. It is talking the talk—but how much can it really do? How much can it sustain this stimulus? Well, Japan's government stock of debt to GDP is simply off the charts, well over 200%. Therefore, the notion that the Japanese government can act in a sustained way to replace the U.S. consumer is, unfortunately, not true.

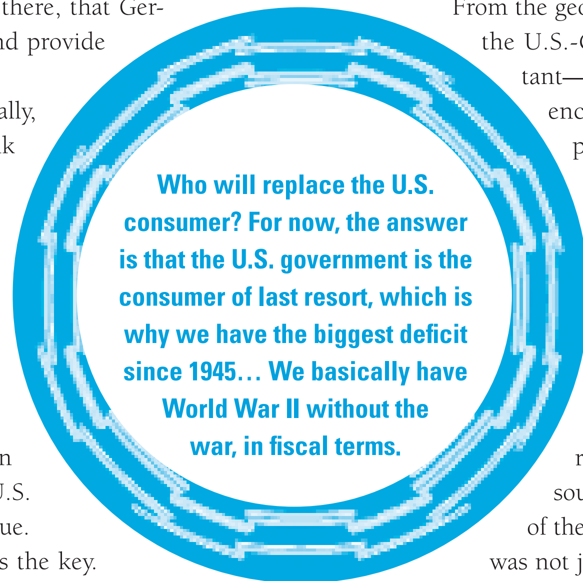
So that leaves China. China is the key. China has a very strong fiscal position—plenty of room to spend. The key thing that China needs to do is to spend the stimulus not on hard infrastructure, meaning roads and bridges and telephone wires and so forth, because that would only reinforce the Chinese export machine and continued dependence on the U.S. consumer. And the U.S. consumer isn't there anymore.

What the Chinese government needs to do is to spend on soft infrastructure, meaning retirement systems and health systems—particularly health. If you think about it, if you directly spend money on hospitals in China, that's spending and that's good for stimulus, but it also has a huge effect on prudential savings by Chinese households. The first time a Chinese family can take a sick family member to a Chinese hospital and not have to pay cash before they even get to see the doctor (which is what happens there), that's the time when the Chinese household will say, rationally, I don't have to save so much of my income because the government's going to provide me a safety net.

With both a retirement system and with a health system, there would be a double effect on Chinese consumption—a shot, at least, at moving the Chinese polity from an unprecedented savings intensity, which it has had: the Chinese savings rate, at over 50%, is absolutely off the charts. To change that, China needs to spend money on these safety nets.

It does seem as if the Chinese government is talking about this; it says it wants to do it. The difficulty is that their system is set up, very effectively, to channel money to provincial governments, which have an incentive to improve the export machine because they have links to business in the export sector. The whole system is created to do that. It's not so cleverly or smoothly oiled to do the domestic safety nets. So, we'll wait and see if China can deliver on this.

From the geopolitical point of view, this makes the U.S.-China dialogue extremely important—the extent to which the U.S. can encourage the Chinese along in this pattern of building up their domestic safety nets will matter a huge amount to the health of the world economy in the next five to ten years.




### *The U.S. Dollar as the Global Reserve Currency*

I've been talking about how to replace the U.S. consumer as the source of final demand. The other half of the so-called Bretton Woods II system was not just that the U.S. consumers spent; it was that the foreigners saved and then they provided these savings to U.S. consumers to carry on their spending. You have to look at this provision of savings to the U.S. by the Chinese government, and others, as dependent on their faith in the U.S. dollar.

This raises the question about the U.S. dollar as the reserve currency. Is that sustainable? Foreign exchange assets held by the Chinese government have increased massively in recent years, but although there's been an astronomical absolute rise in dollars held by China, helping to finance the U.S. consumption binge, we should not presume that this will carry on forever. One warning sign is that the dollar's share of China's foreign assets has fallen.

There are many reasons why the Chinese might want to reconsider this export-driven growth model and, therefore, reconsider the logic of funneling so much money off into U.S. dollars. The first reason is that the export model has made China very vulnerable to a growth shock. The story of decoupling—that China, and others, would just sail along and not be vulnerable to a financial crash involving U.S. mortgage finance—proved to be completely wrong: because their economy was so geared to exports, Chinese GDP crashed along with the U.S.'s.

It's also the case that although China has grown its exports massively, jobs have not grown at quite the same pace. Their

strategy is highly capital-intensive. If their real motive is to create jobs for Chinese workers to try and keep the lid on potential political dissatisfaction, this strategy actually doesn't work very well. If you want to create jobs, you'd be better off focusing more on domestic markets.

Politically, too, there are a lot of rumbles now about whether China wants to carry on buying these U.S. assets. When Tim Geithner, the U.S. Treasury secretary, went recently to China and gave a speech to students at Beijing University and said that U.S. assets are safe, the audience just laughed. They laughed. I mean, they just don't believe it. They don't think that assets in U.S. dollars are safe, and when their government plans on funneling money into U.S. instruments, there's a question about whether that's sustainable politically, even in a country which is not a democracy. At some point, popular discontent about China's international savings in a currency that's probably going to depreciate will come back to bite them.

We also see this manifested in things like Premier Wen Jiabao saying, could we have a guarantee, please, for China's total holdings. Not easy to see how the government would deliver that, but just the fact that they asked for it suggests the level of discomfort the Chinese leadership feels. There was another approach from a Chinese monetary official who came to New York and told one of the newspapers, we hate you guys but we don't have any choice at the moment.

There is a great push in the Chinese leadership to think of how they can get out of this trap of buying more dollar instruments. One crazy idea they suggested was that the IMF should enhance the role of special drawing rights (SDRs)—this 1960s creation of a sort of proto-international currency—the idea being that if the IMF issued lots of these SDRs, then China could hold its reserves in SDRs and it wouldn't have to hold these pesky dollars.

Another thing that China's experimented with, again showing their discomfort about the status quo, is talking to Argentina, Indonesia, other countries about trying to get them to use renminbi more—both in their trade transactions and in other dealings.

I think the Chinese leadership is hoping that one day they can export the capital that they want to export, but export it in their own currency so they're not taking dollar currency risk. Unfortunately, none of their ideas are going to get them out of this trap with any elegance or success. There's kind of a law of conservation of dollar exposure. For people out there who hold dollars, as the dollar depreciates in the future, there are going to be real losses. The Chinese can't just magic away this huge risk they've taken by accumulating $1.5 trillion of government reserves held in U.S. dollars.

So they can't make it disappear and, in an ironic kind of way, it's precisely the fact that most people expect the dollar to depreciate on the, roughly, 5-year horizon, that would cause borrowers to be looking to borrow in dollars. They don't want to borrow in renminbi, which will probably appreciate.

The point is, there's lots of potential for some instability around the dollar as the world's reserve currency. For the moment, there's no attractive alternative to the U.S. dollar, so I'm not saying it's going to happen on the short view, but the world has a reserve currency that it doesn't like and that's not necessarily a sustainable situation.

There are two kinds of dollar crises one can imagine. There's the unplanned kind of dollar crisis, when you reach a point where the traditional reasons keeping the Chinese in dollars (the dollar is an easy thing to hold because there are so many Treasury bills out there and you can buy it and it's very liquid) gets outweighed by the sense that the U.S. fiscal deficit is so big that the ability of the Treasury to repay is somewhat in question, or that U.S. inflation picks up and scares people out of dollars. And you're going to get a rush to the exit, where lots of central banks and lots of private investors who have accumulated enormous dollar positions just see the dollar going down and they all rush to get out first and that precipitates one kind of dollar crisis.

But the other kind, which I think is just worth considering, is a deliberately created dollar crisis where you have something like a Taiwan Straits standoff between U.S. and China. The Chinese might figure that by selling their Treasuries holdings, they could stimulate a financial crisis in the U.S, and that would be a legitimate weapon of war and they could use it in this fashion. We did a study at the Council of Foreign Relations precisely on this question, about how the dollar weapon could be used by the Chinese or by other creditors to punish the United States economically at a time when it was under stress.

The Chinese have so much ammunition here that they can create, ahead of time, a predictable downward trend in the dollar which would induce the private markets not to equilibrate, but to do the opposite—to jump on the bandwagon. I think the Chinese can use this weapon extremely effectively, if they want to. It would cost them something, but in a crisis scenario, they might judge that cost to be worth it. So I think that's a vulnerability latent to the accumulation of dollars by the Chinese government that perhaps people should think about a little bit more.

In the end, there's going to be some adjustment—the U.S. will have to save more and consume less, and the Chinese will have to rely less on exports, and there will be a rebalancing of the world economy. But it's important to recognize that this rebalancing will not be without some pain because rebalancing means that you have to reallocate your assets within your own economy. There will be frictional costs. It all adds up to the point that trend growth, when we get out of this trouble, will probably be lower than it was in the past.

So to summarize the economic challenges that I've gone through, we've got green shoots but they're from a very low base and there's a limit to that. And in the medium term, there are structural problems that would cause one to be cautious about the medium-term growth. Replacing the U.S. consumer is very difficult. When you go down the list, you don't see all these candidates putting their hands up.

Finding our way out of the situation in which the world has a reserve currency that the world doesn't like is something we don't know the answer to. Rebalancing the world's economy so that the U.S. exports more and China exports less can be done. I think it will happen, but there will be with frictional costs to get there.

And the third obstacle to recovery, fixing finance in a regulatory sense, is tough because there are really no silver bullets whatsoever.

U.S. trend growth was already on a downward trajectory and the crisis, I think, makes it worse for a number of reasons. The frictional cost of transitioning is going to have a reducing effect on trend growth. You've got discouraged workers who've become unemployed in this downturn and then they become discouraged and leave the workforce, and represent a sort of permanent reduction in the workforce.

Labor mobility could be negatively impacted because people have negative home equity so it's tougher for them to move fast and move to the new jobs. So you've got less flexible labor markets. And higher cost of capital, partly because government debt goes up and crowds out private lending when the economy comes back, and partly because you get higher risk premia because capital markets can be scared and demand more of a premium for taking risk.

Capital allocation may be politicized in an environment where the government has taken huge ownership stakes in lots of financial sectors, not only here, but abroad as well. And you've got higher taxes in the future to service this mountain of debt that you've taken on. So there are a lot of reasons to think that trend growth is going to come down.

## GEOPOLITICAL CONSEQUENCES OF THE CRISIS

What about the distribution of power? What does a future of slower growth do to U.S. power relative to others? U.S. growth forecast in 2009 is 4.8% lower than in 2007—but relatively, the U.S. is expected to perform better than China, Russia, Brazil and the Euro area. Even though China is still growing at a 6.5 percent forecast for this year, that's 6.5 percent less than it grew in 2007. So, projections that show when China will become a bigger economy than the U.S. economy are, if anything, pushed further out into the future. You can do the same thing with 2007 versus 2010 and get a similar answer: The U.S. growth loss is actually smaller than other countries.

So the short-term impact doesn't look too bad. But let me just highlight one risk to the U.S., which is the fiscal Achilles' heel—this massive accumulation of government debt. U.S. government borrowing is way up. I submit that U.S. power depends on the U.S. government's ability to borrow in a crisis. The attractiveness of U.S. Treasuries has been an important factor when crises hit, because money flowed to U.S. Treasuries because of the so-called "safe-haven effect." So when you have an economic crisis, like the post-Lehman Brothers environment, the Treasury yields—the U.S. government's cost of borrowing—went down. Or, for example, in the lead-up to the Iraq War, what you had was this bizarre spectacle of, on the one hand, the Russians and Chinese voting against the U.S. position on Iraq in the U.N. Security Council but at the same time putting their money in dollars and therefore, effectively, lending money to the U.S. and financing the Iraq War that they had opposed.

You get these safe-haven flows so that just when power matters for the U.S, the U.S. has maximum freedom to finance its policies. And so if you have a loss of credibility and questions about the dollar's status as a reserve currency, I think that is a question mark for U.S. power in the future.

Another way of thinking about this geopolitical distribution of power is to think not just about the U.S., but the U.S. plus its allies. So that even if the U.S.'s share of GDP was to hold up in the world, what about its allies? We know that Western Europe has been badly hit. So one traditional ally is

going to be growing slowly. We know that Japan has extreme demographic troubles, and that's another traditional U.S. ally that is likely to lose share of global GDP. The IMF projects that autocracies will overtake democracies' share of global GDP within the next couple decades. While that's not foreordained, it clearly does not bode well for U.S. interests in the world.

One final thought. The geopolitical implications of all this depend a lot on what happens in one country, namely, India, because India is a democracy and has the size and enormous potential to shift the balance, if you think in terms of democracies versus autocracies.

The good news is that there are measures that suggest one could be optimistic about India going forward: Savings as a percentage of GDP, which traditionally lagged in India and had been a missing component in the Indian growth story, has shot up recently. And equally, foreign direct investment in India has shot up as well. This trend is only reinforced by the recent Indian election, where a pro-reform government did extremely well. And that's likely to consolidate India's path towards open and free market reforms.

If India shifts from being a neutral, non-aligned power into being part of the pro-U.S. camp, and if it grows simply as the IMF forecasts, it could really have quite a big impact on changing the speed with which democracies and pro-U.S. countries are losing their share of the global GDP. The U.S.'s long-run interests depend a lot on what happens in India.

## CONCLUSION

Three quick points: In terms of the geopolitical bottom line, coordination with the G-7 is important to patch holes in the financial regulatory framework. There's huge potential for finance to move offshore to get around regulations, so if we're going to get any of this financial regulation right, we need to work with the G-7 on that.

We need to coordinate with China in terms of rebalancing savings and consumption, and we need to think very hard about our alliance with India and see that as a key to mitigating the speed of democratic decline worldwide.

SEBASTIAN MALLABY is director of the Maurice R. Greenberg Center for Geoeconomic Studies, deputy director of the David Rockefeller Studies Program, and Paul A. Volcker senior fellow for international economics at the Council on Foreign Relations (CFR). He joined CFR in 2003 from the Washington Post, for which he continues to write a column. Before joining the Post in 1999, Mallaby spent 13 years with The Economist, during which he served as chief of the Washington and the Tokyo bureaus. His most recent book is More Money than God: Hedge Funds and the Making of a New Elite (2010). Mallaby can be reached at smallaby@cfr.org.