

Global: Rebalancing or Relapse?

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An unbalanced world economy needs a new recipe for sustainable growth. A two-engine global growth dynamic has been pushed to excess. The over-extended American consumer can no longer carry the demand side of the equation. And an over-heated Chinese economy can no longer power the supply side. Nor can the world, as a whole, sustain the massive imbalances -- financial and trade -- that have arisen from this lopsided growth paradigm. But risks are building that a rebalancing may not go smoothly. As China and the US now slow, new growth engines must fill the void. Absent that important shift in the mix of global growth, the imperatives of rebalancing could well give way to a global relapse.

There can be no mistaking the disproportionate impetus that the US and China have provided to world economic growth in recent years. Over the 1996 to 2003 period, our estimates suggest that these two economies directly accounted for 49% of world GDP growth -- well in excess of their combined 33% PPP-based share in the global economy. Adding in the indirect effects due to trade linkages, and the total contribution could easily be in the 60-70% range. The US contribution shows up mainly on the aggregate demand front. Over the past eight years, growth in US personal consumption expenditures averaged 3.9% in real terms. That's about one percentage point faster than trend growth over the prior 15 years and about 75% faster than the 2.2% gains elsewhere in the developed world. It is hardly an exaggeration to conclude that the American consumer has been the principal engine on the demand side of the global growth equation since 1995.

China has played an equally important role in driving growth on the supply side. Chinese real GDP growth averaged 8.2% over the 1996 to 2003 period -- more than three times average gains of 2.7% in the advanced nations and more than double average gains of 3.5% elsewhere in the emerging market and developing economies of the world. Yet the contribution of the Chinese producer is probably much greater than the GDP statisticians imply. Industrial output growth in China has averaged about 12% since 1995 -- fully 50% faster than gains in the official GDP growth metric. With a relatively undeveloped services sector -- less than 35% of Chinese GDP in 2003 -- and a relatively small consumption share -- 54% of Chinese GDP in 2003 -- surging industrial activity accounted for 54% of the cumulative increase in Chinese GDP since 1990. The impacts of this industrial-production-led strain of growth are global in scope. China now consumes a highly disproportionate share of worldwide demand for industrial commodities -- having accounted for 25-30% market shares in global consumption of aluminum, steel, iron, and coal in 2003. Moreover, China's investment-led impetus resulted in a 40% surge in imports in 2003 -- underscoring its emerging role as a growth engine for

externally-dependent economies such as Japan, Korea, Taiwan, and Germany. At the margin, there can be little doubt of China's increasingly dominant role in driving the global production dynamic.

Both of these engines have now shifted to lower gears. Growth in US consumer demand moderated to a 1.6% increase in 2Q04, well below the 4.2% pace of the prior four quarters and the weakest quarterly performance in over three years. Largely reflecting this moderation, the consumption share of US GDP has receded from a record high of 71% in mid-2003 down to about 70%. While this is progress, it is only very limited, at best, in restoring some sense of balance to the US economy. From 1980 through 2000, the consumption share of US GDP averaged about 67%; by reversing only one percentage point of the recent four point overshoot, the American consumer has completed only about 25% of the journey on the road to normalization. A similar result is evident for the Chinese producer: Growth in China's industrial output slowed to 15.5% in July -- a four percentage point reduction from peak growth rates of around 19.5% earlier this year. In my view, China needs to bring its production comparisons down into the 8-10% range in order to achieve a soft landing. The recent slowing of Chinese industrial output growth has achieved about 40% of the ten percentage point deceleration that a soft landing would require.

Downshifts in the US and China are now setting in motion the first phase of global rebalancing. Yet on both counts, as noted above, progress has been only limited -- the bulk of the slowing still lies in the future. Moreover, for both economies, the moderation of growth is largely a reflection of the internal dynamics of the business cycle. In the case of China, the downward impetus has come from a conscious shift to policy restraint in an effort to slow an overheated Chinese economy; this is critical to temper emerging imbalances that, if left unattended, could prove increasingly destabilizing in the future. Signs of such imbalances have been especially evident in the property markets of coastal China. They are also increasingly evident in the auto sector, where trade reports now suggest that inventories of unsold vehicles are piling up much more rapidly than the official figures suggest. With the Chinese slowdown having only just begun, senior Chinese officials have stressed recently that their commitment to a slowdown has now reached a "critical stage." As policy restraint remains in place, China's domestic investment should slow, tempering its supply-led impetus to global growth. A secular increase in Chinese export penetration is likely to be a partial offset.

For the American consumer, the recent moderation is less of an immediate response to policy restraint and more a by-product of the tough internal dynamics of an over-extended household sector. Nowhere does this show up more vividly than in the renewed sharp decline in the personal saving rate, which plunged to just 0.6% in July -- well below the already depressed post-1995 average of 2.7%. Lacking in job and wage income growth, consumers have drawn the bulk of their support from tax cuts and equity extraction from asset markets. However, with future tax cuts and sharp house-price appreciation unlikely, US consumers are likely to be increasingly mindful of depleted income-based saving rates. Add in a likely back-up in interest rates that should boost the carrying costs of record debt loads, together with sharply higher energy costs, and the squeeze on discretionary purchasing power could become all the more acute. While it's always tough to bet against the American consumer, the noose finally appears to be tightening. I continue to believe that a US consumption adjustment will end up being the single most important source of moderation on the demand side of the US and global economy over the next couple of years.

Global rebalancing is not a one-way street -- it entails far more than just slowdowns in the US and China. Equally critical, in my view, is the renewal of growth elsewhere in the world -- namely,

autonomous support from domestic demand, especially private consumption. On that count, the global economy remains woefully deficient. The Asian consumer is effectively missing in action.

Thailand is perhaps the only exception, as consumption dynamics remain disappointing in most of the region -- especially in Japan, China, and Korea. For a while, there was hope that the Japanese consumer was about to awake from a decade-long slumber; however, with Japanese consumption now down for three months in a row in the period ending July 2004, those hopes have been all but dashed. Similarly, a likely popping of the Chinese property bubble spells new pressures on consumption trends in coastal China. And the Korean consumer is still reeling from the impacts of the bursting of credit and property bubbles in 2003. Nor is there much of an offset evident in Europe, where domestic demand continues to eke out relatively anemic gains. While that's especially true in Germany, which makes up fully 30% of Euroland GDP, gains elsewhere in the region can hardly be described as vigorous. Europe is, at best, a 2% growth story over the next couple of years, according to the latest forecasts of our European economic team. If the US and China now slow, as I suspect, Europe is hardly capable of filling the void that could be left by the American consumer and/or the Chinese producer.

Partial rebalancing is a distinct negative for the global growth outlook. Our current baseline forecast calls for 4.7% growth in world GDP in 2004 -- the first year of above-trend growth in four years. However, we continue to expect that resurgence to be short-lived. Our 2005 forecast calls for global growth to decelerate to 3.8% -- a slowing of nearly one percentage point from this year's estimated gains and only fractionally above the longer-term 3.7% trend. Key to our slowdown call is likely deceleration in both the US and China. China and the US combined account for about 34% of total world GDP as measured on a purchasing power parity basis. US economic growth is expected to decelerate by 0.6 percentage point in 2005 (from 4.4% in 2004 to 3.8% in 2005) and Chinese economic growth is expected to slow by 1.5 percentage points (from 9.0% in 2004 to 7.5% in 2005). Collectively, projected downshifts in these two economies knock about 0.5% off world GDP growth in 2005 -- a direct effect of 0.35 percentage point and an indirect effect on other economies of about 0.15 percentage point. Consequently, if downshifts in the US and China are not countered by improved growth prospects elsewhere in the world, there is a distinct possibility of a major shortfall in global activity.

That takes us to the biggest risk of all: Any unexpected growth shortfalls could easily push growth in a still fragile world economy back into the 2.5% to 3.5% zone in 2005. Growth in that range would then leave the world dangerously near its stall speed and, therefore, highly susceptible to a shock. Recent developments on the energy front are especially worrisome in that regard (see my 20 August dispatch, "Oil-Shock Assessment"). With oil prices closing on \$50, the risks of global recession were mounting. At \$40, those risks would obviously be a good deal lower. The current price point of around \$44 sits precariously between these two extremes. But whether it's an oil shock or some other unexpected blow, the verdict is the same: With China and the US slowing and the rest of the world unwilling or unable to pick up the slack, a partial rebalancing could well heighten the possibility of a global relapse in 2005.