



## Global Rebalancing

By John H. Makin

The global economic and financial picture is changing rapidly. A review of some of the key elements is in order, as the U.S. economy has slowed rapidly and the Federal Reserve has responded aggressively with rate cuts, while the Bank of England's tough policies pushed one of the United Kingdom's largest mortgage lenders, Northern Rock, to the brink of collapse as a bank run on that suddenly beleaguered institution ensued. Meanwhile, Japan, still the world's second-largest economy—though perhaps the least dynamic of the major ones—slipped into negative growth at a 1.2 percent annual rate in the second quarter after having initially reported growth over 2 percent. The rate-boost-obsessed Bank of Japan finally decided to stop raising rates, and, to add to the complexity of the picture, Japan's relatively new prime minister Shinzo Abe resigned, unable to provide the leadership sorely needed in a nation lacking economic and political direction.

Elsewhere in Asia, China's growth has accelerated even further as inflation rises faster, and the Shanghai stock market has pushed its year-to-date increase above 100 percent—serious bubble territory. European growth and inflation have been steady, but, much to the embarrassment of the Bundesbank, German regional banks were found to have been knee-deep in risky subprime mortgage securities. The European Central Bank had to aggressively add funds to the banking system to calm what could have been a panic.

### The United States Heads for Recession

A rapid change in outlook for the U.S. economy, with serious consequences for U.S. and global

credit markets, was clearly linked to an abrupt shift in the Federal Reserve's policy stance from one that emphasized inflation risks to a primary focus on risks of slowing growth. The transformation in the Fed's outlook was extraordinarily rapid, but appropriate, in view of a quick deterioration of underlying economic conditions. Three related events prompted the change in Fed thinking.

First, as the Fed acknowledged on August 17 when it cut its discount rate from 100 basis points above the federal funds rate to just 50 basis points above it, "Financial market conditions have deteriorated and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward." With that statement, the Fed was responding, appropriately, to a virtual panic in American credit markets that saw, on some days, huge flows out of supposedly riskless money market funds into zero-risk, short-term Treasury bills. The Fed's efforts helped to restore confidence, and by the end of August conditions in credit markets, while far from normal, were somewhat calmer.

The second major event spurring the Fed's transformation from concerned about inflation to fighting recession was the annual late-summer economic symposium at Jackson Hole, Wyoming. The event is organized by the Fed's Kansas City branch, but most of the governors of the Fed system participate in it. The theme of the Jackson Hole symposium was "Housing, Housing Finance, and Monetary Policy"—a remarkably prescient choice given that the conference topic had been selected well in advance of the emergence this summer of the tumultuous events in the U.S. housing and credit markets. Two major themes emerged from the impressive set of research papers presented at

Jackson Hole. The first, featured in a paper by Edward Leamer of UCLA, reminded the participants—including Chairman Ben Bernanke—who listened carefully to all of the presentations that over the last half century every housing downturn comparable to the magnitude of the one currently underway in the United States has translated into a U.S. recession.

Another paper on housing and consumer behavior by John Muellbauer of Oxford University presented convincing evidence that it is credit market problems associated with housing weakness, not necessarily wealth losses, that can severely depress consumption. With credit problems in the United States intensifying, Muellbauer's paper carried a particularly compelling message for the members of the Fed's Open Market Committee, virtually all of whom were in attendance. The paper may also have suggested to the FOMC members listening closely to Muellbauer's presentation that some of the board's staff models might not fully capture the negative effects flowing from the housing slowdown and associated credit market disruptions to spending by U.S. consumers.

The third element in the transformation of the Fed's focus from inflation to lower growth was the appearance, during the first half of September, of sharply weaker employment and retail sales numbers for August. Employment actually fell by 4,000 in August against an expected increase of 100,000. The expected increases reflected the view that while credit market and housing problems had intensified, the effects on employment would not show up immediately. Beyond the report for August, employment figures for the previous two months were revised downward, so that the monthly average increase in employment fell from 135,000 in the three months ending in July to 44,000 in the three months ending in August. While some unusual features like a drop in government sector employment may have pushed the numbers down, even excluding weaker government figures, the three-month average increase in private payrolls was just 72,000 a month—sharply below expectations. The August figure was only 21,000.

August retail sales provided a strong indication that consumer spending was weakening. The three-month average monthly growth rate of retail sales dropped from 4.8 percent in July to -0.1 percent in August. The same sharp deceleration showed up in all of the various measures of retail sales, suggesting that third-quarter consumption growth estimates would have to be revised downward.

The combination of credit market problems, the Jackson Hole papers emphasizing how much a housing slowdown could hurt the U.S. economy, and the actual numbers for August combined to convince the Fed to reduce both the fed funds rate and the discount rate by 50 basis points at its meeting on September 18. The

Fed's statement—"The tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally"—clearly echoed the message of the papers at Jackson Hole. Beyond that, by cutting 50 basis points, the Fed gave itself another six weeks to review economic data before its October 31 meeting, thereby forestalling the potential need for an awkward intermeeting rate cut.

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## The United Kingdom's Bank Run

The Bank of England faced a more ambiguous situation with U.K. credit markets and the U.K. economy than that faced by the Federal Reserve. In August, Bank of England governor Mervyn King made clear his intention not to join the Fed and the European Central Bank in flooding credit markets with funds in the face of sharply higher interest rates faced by some borrowers. King appropriately observed that such behavior carried the risk of rewarding those who had engaged in careless borrowing and lending practices. The "moral hazard" issue remains a serious one facing all central banks. However, Northern Rock proved to be a weak link in the U.K. credit chain. Northern Rock was an innovative mortgage lender in the sense that it funded itself largely by borrowing in credit markets rather than through funds provided by depositors. When credit markets froze up, Northern Rock was unable to secure funding for its mortgage loan book and on September 13 was forced to ask the Bank of England for a bailout.

The sudden emergence of Northern Rock's problems caused a panic among its depositors and triggered a virtual run on Northern Rock funds. On Friday, September 14, Northern Rock depositors lined up outside branch offices to withdraw their funds. Pictures of the run on Northern Rock, reminiscent of bank panics during the Great Depression of the 1930s, appeared on the front page of the weekend edition of the *Financial Times* on Saturday, September 15. The Bank of England and the British Chancellor of the Exchequer were driven to the appropriate decision that no depositor should be unable to

withdraw funds from a depository institution. To decide otherwise would precipitate a run on other financial institutions. By Tuesday, September 18, the lines in front of Northern Rock branches had largely disappeared, but the clear distinction between depositors who lose no money and shareholders who can lose all their money perhaps had not been put forward as forcefully as it might have been. Consequently, British credit markets continued to be in a highly nervous state while charges of moral hazard tied to the sudden shift of the Bank of England to bailout stance lingered in the air.

The Northern Rock episode underscored how quickly things could deteriorate in today's nervous credit markets and probably softened central banks' determination to emphasize moral hazard problems over the need to accommodate financial institutions. Bernanke, an eminent scholar of the effects of banking problems on the Great Depression, can hardly have failed to notice the pictures on the front page of the weekend edition of the *Financial Times*.

### Japan Stagnates—Again

Almost unnoticed amidst the credit-market turmoil in the housing-driven Anglo-Saxon economies was Japan's quiet slippage into ominous negative growth. Sharp downward revisions to second-quarter capital spending that appeared early in September resulted in a negative 1.2 percent annual growth rate for Japan's overall economy—somewhat shocking in view of the fact that the initial reports on the quarter had put the growth rate at above 2 percent. Almost simultaneously, although not primarily driven by the weakness in the economy, Japanese prime minister Abe was forced to resign after a tenure of only twelve months. Meanwhile, Japan's deflation persisted with the core inflation rate (excluding food and energy) falling at a 0.5 percent year-over-year rate in July, marking a deceleration downward from the April drop of 0.2 percent. Against this negative economic background, Japan's stock market fell sharply, by more than 10 percent from July to mid-September, while Japan's currency appreciated as nervous carry trade investors brought money home to Japan. This remarkably negative set of economic and financial developments convinced the Bank of Japan, albeit reluctantly, to announce no increase in its official lending rate after its July 18 meeting.

While Japan's economy has not been highly dynamic, it has contributed to global growth with year-over-year GDP increases averaging about 2.5 percent over the last several quarters. Clearly, a slowdown in Japanese growth would be less than helpful in the global economic environment. As in much of Asia, Japan's growth depends almost entirely on continued strong growth of exports to

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China as the domestic economy is virtually stagnant due to a fiscal drag of about 1 percent and weak wage growth. The sharp drop in Japanese capital spending is an ominous sign regarding the perceived outlook for continued rapid growth of exports. Export volume to the United States has slowed sharply while exports to China have continued strong.

### China Booms and Overheats

In a world of slowing economic growth and turbulent credit markets, China remains a bastion of vibrant economic growth. Its stock markets have been unfazed by the drop in stock markets elsewhere, with the Shanghai market up more than 100 percent so far this year and the Shenzhen market up over 170 percent.

China's economy is growing so fast that an emerging slowdown in exports to the United States could prove to be a good thing by helping to reduce the risk of overheating. About 25 percent of Chinese exports, including shipments through Hong Kong, goes to the United States. Another 22 percent goes to the European Union. If the U.S. economy continues to slow, Chinese exports will slow. That export weakness will intensify if European growth slows more—something that may be underway.

Underlying China's robust growth potential is the fact that that country continues to pursue the world's largest public works projects. The government has ample funds to continue spending rapidly on the construction of infrastructure in twenty cities with populations over 5 million, roads to connect those cities, and the means to move huge volumes of water from locations as remote as Tibet to China's water-starved northeast provinces and municipalities, including Beijing.

As a result of its massive public works spending combined with strong exports to most of the world except the United States, the Chinese economy is experiencing a virtual inflationary boom. August retail sales were up 18 percent on a three-month annualized basis while domestic auto sales are rising at a 25 percent annual rate. China's

consumer price inflation is rising at a 12 percent, three-month annualized rate—up sharply from about 3 percent earlier in 2007. While Chinese exports to the United States declined at a 7 percent annualized rate in the three months ending in August, exports to the European Union rose at a 50 percent annualized rate, suggesting that European growth has been holding up well relative to U.S. growth.

The Chinese are taking modest steps to reduce inflationary pressure by raising reserve requirements in the banking system and raising interest rates, although interest rates are still negative in real terms. China's real currency appreciation has been modest, and the country has done nothing to reduce massive trade surpluses and resultant accelerating foreign exchange reserve accumulation. Given the sharp rise in inflationary pressure, more and faster currency appreciation would be a logical move for China to employ as a means to help control inflation. The result would be reduced liquidity growth and somewhat slower exports that would take some of the inflationary pressure off of China's resources. China's determination not to address its inflation problem seems to match Japan's determination not to address its deflation problem, with the result being that inflationary overheating is likely to continue in China while deflationary slow growth is likely to persist in Japan. The pressure for a weaker dollar constitutes a stabilizing force for China and a destabilizing one for Japan.

## Europe Slows Gradually

European area growth has slowed modestly from an annual rate of just over 3 percent at the start of the year to about 2.5 percent at midyear. The credit market turmoil emanating from Germany's regional banks appears not yet to have unduly threatened continuation of overall growth at about 2 percent for the balance of 2007, although EU growth will slow to about 1.5 percent in 2008.

The European Central Bank has continued to emphasize inflation risks, having raised its official refinancing rate by 25 basis points to 4 percent early in June. That said, the problems in the credit markets and large injections of liquidity coupled with fears of a global growth slowdown have probably left the ECB on hold for the indefinite future. Should growth slow more quickly below 2 percent as early as late 2007, the European Central Bank could follow the Fed in emphasizing slower growth over inflation concerns, especially in view of the rapidly elevated political pressure coming from the new French president, Nicolas Sarkozy, to do just that. In the near term, however, Sarkozy's outspoken criticism of the ECB is probably

counterproductive, reducing the chance of any additional accommodation in the absence of a sharp growth slowdown.

## Global Rebalancing

The next six months will show how well the world economy and the U.S. economy can perform without a strong contribution from U.S. consumption growth. The credit- and housing-fueled growth of U.S. consumption at a persistent 3 percent rate over much of the last several years will not continue and could turn negative in coming months. Meanwhile, U.S. capital spending will also probably slow, as will spending on non-residential construction. A U.S. recession is likely, despite the Fed's move to address lower growth by cutting interest rates. The Fed's initial easing move usually coincides with the onset of a recession. Weaker global demand growth will be exacerbated somewhat by the continued weakness of Japanese consumption, but that is not a new factor.

The adjustment process—global rebalancing—will include continued dollar weakness and a fall in U.S. consumption, invariably a sufficient condition for a U.S. recession. For some exporters to the United States, the combination of a weaker dollar and slowing U.S. demand growth will sharply curtail exports and thereby slow the growth of export-driven economies. For overheating economies like China's, this is probably a stabilizing factor that could be made more so if the Chinese were to allow their currency to appreciate more rapidly. For European exporters, problems may also arise in view of the ECB's unwillingness to cut rates and the modest growth of demand in Europe. Spain's housing sector is due for a sharp correction. Emerging markets may also experience slower growth in the face of a weaker dollar coupled with slower growth of U.S. demand for their exports.

The generally robust global economy outside of the United States—with the exception of Japan—can and should help to cushion the U.S. growth slowdown by continuing to enhance the growth of U.S. net exports. It is to be hoped that that process will not be impeded by increasing protectionist pressure in Congress, which would prove counterproductive. Broadly, it is important to remember that the global economy is achieving a much-sought rebalancing away from dependence on U.S. demand growth and large U.S. trade deficits and toward more dependence on global demand growth and lower U.S. external deficits. That said, the process may not be as painless as some have imagined.