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Tough Flying Conditions in the Global Economy

By Stephen Roach

[*Stephen Roach is among the most acute analysts of the risks inherent in the chronic US balance of payments deficit and low savings rates. Here he steps up his warning of the dangers of a meltdown of the global economy by a close examination of the vulnerability of the US and Chinese economies to a slowdown in US consumption related to oil and other factors. Japan nowhere figures in his simple story of forces driving the global economy, the implications for Japan and Asia are no less stark than those for China and the US. Japan Focus.*]

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Not surprisingly, an unbalanced global economy is struggling under the weight of the energy shock of 2005. This has not been lost on world financial markets. Stock markets have sagged on the fear of demand risk and bond markets have backed up as central banks sound the alarm over incipient inflation. This underscores the inherent risks of the fabled four-engine global airplane. This gigantic 747 is now flying on just two engines, fueled by the American consumer on the demand side and the Chinese producer on the supply side. If the demand engine sputters, added thrust from the supply engine may be destabilizing. That's a legitimate concern in late 2005. If US consumption falters in the face of ongoing vigor from Chinese production, it may be difficult for an already wobbly plane to maintain its altitude.

Nothing comes close to equaling the impact of the American consumer in supporting the demand side of the global growth equation over the past decade. By our reckoning, over the 1996 to 2005 interval, real consumption growth in the United States averaged 3.75% per annum -- fully 70% faster than average gains of just 2.2% elsewhere in the developed world. The world drew support from an extraordinary transformation in the US consumption model -- a morphing of income-based consumers into asset-driven spenders and savers. While growth in real disposable personal income remained on trend at 3.3% over the past 10 years, real consumption growth exceeded real income growth by about 0.5 percentage point per annum over this period. Drawing support first from equity wealth effects in the latter half of the 1990s and then from housing wealth effects over the past five years, the American consumer became the world's consumer.

But at a steep cost. America's wealth-based consumption binge pushed the income-based personal saving rate down by five percentage points over the past decade -- taking it deeper into negative territory than at any point since 1933. Alan Greenspan has estimated that equity extraction from residential property has been sufficient to have accounted for all of the decline in personal saving since 1995 (see his September 2005 working paper, co-authored with James Kennedy, "Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences"). Of course, the monetization of wealth from homes hardly came out of thin air. It required an enormous build-up of debt -- sufficient to take up the outstanding volume of household indebtedness by 20 percentage points of GDP over the past five years, equaling the gain over the preceding 20 years. Moreover, despite historically low market interest rates, the debt overhang pushed up the household-sector debt service burden -- interest expenses as a share of disposable personal income -- to a record high in mid-2005. The world's consumer has taken the concept of macro risk into an entirely different realm.

The current energy shock is a very different threat to a wealth-based consumer than it is to an income-supported consumer. That's especially the case since it hits US households when they are running a negative saving rate. In the three previous energy shocks -- 1973, 1979, and 1990 -- the personal saving rate averaged about 8%. US consumers had a cash cushion they could draw upon in order to support lifestyles. A negative saving rate offers no such cushion. Dick Berner has estimated that higher energy product prices are the functional equivalent of an annualized tax of around $130 billion on US consumers, or about 1.4% of total disposable personal income. With a negative saving rate, a significant portion of that tax will undoubtedly be funded by a retrenchment of discretionary consumption. The world's consumer is now facing major cash-flow pressures heading into the all-important holiday buying season.

Meanwhile, halfway around the world, nothing seems to be stopping the Chinese producer (see my 21 October dispatch, "Wrong on the China Slowdown"). With GDP growth holding above 9% through 3Q05 and industrial output growth continuing to run north of 16%, a seemingly impervious Chinese economy seems all but oblivious to potentially ominous developments in its external sector. This could be an accident waiting to happen. In an energy-shocked environment, China's export-led growth dynamic is at growing risk of decoupling from its major source of end-market demand -- the American consumer. If US consumption slows as I suspect, an inventory overhang could quickly emerge in China that would undermine production support in the months ahead.

That may not be idle conjecture. Nicholas Lardy of the Institute for International Economics drew my attention to an ominous build-up of Chinese inventories that predates any impacts of the energy shock. According to China's National Development and Reform Commissions (NDRC) -- the modern-day version of the old central planning agency -- the accumulation of finished goods inventories accounted for fully 20% of the increase in China's nominal GDP in the first half of 2005. This represents a major step-up in the inventory boost to Chinese economic growth. By way of comparison, finished goods inventories accounted for just 1% of China's nominal GDP growth in 2004. To the extent that Chinese economic growth was already drawing unusual support from inventory accumulation before the energy shock hit, any energy-related shortfall of external demand could lead to an increasingly destabilizing overhang of domestic production.

Yet the China macro call is not just an inventory call. The Chinese economy suffers from a deeper strain of imbalances. With private consumption having fallen to a record low of just 42% of GDP in 2004 and likely to have declined further in 2005, China is lacking a key building block of self-sustaining internal demand. This is not surprising. Reflecting the ongoing pressures of the massive headcount reductions traceable to state-owned enterprise reform, Chinese consumers are predisposed toward precautionary saving. The lack of a well-developed safety net only reinforces this tendency. As such, China's growth dynamic has become increasingly reliant on exports and on the investment in infrastructure and factories required to build a state-of-the-art export platform on a scale the world has never seen. Collectively, exports and fixed investment, which now account for over 80% of Chinese GDP, are still surging at close to a 30% annual rate. The rest of the economy is simply not pulling its weight.

The risk of the China call is that we extrapolate this year's forecast errors into the future. Just because China did not slow in 2005, doesn't mean that it's full steam ahead for years to come. It is, of course, quite possible that Chinese officials turn up the dials on

investment and fiscal policy if its export markets weaken. That was exactly what happened in the Asian crisis in 1997-98 and again in the mild global recession of 2000-01. But in those two earlier periods, the combined share of exports and fixed investment amounted, on average, to "only" about 55% of Chinese GDP -- far short of the current 80% share.

China can only go to this well for so long before it hits bottom. Unless internal private consumption quickly springs to life, China's export- and investment-led growth juggernaut may simply outstrip its global support base. If the American consumer pulls back in an energy-shocked environment, as I suspect will be the case, those risks need to be taken seriously.

Sure, the world has other options. Maybe Japanese or even European consumers could ride to the rescue. Here, I think there is a serious phasing problem. While I am quite taken with the upside potential for non-US consumption, I believe such rebounds are likely to come later rather than sooner (see Consumer Rebalancing, October 4, 2005). Moreover, in the early stages of their consumption recoveries, the Japanese and European dynamics are likely to be glacial rather than vigorous.
While we are increasingly optimistic on prospects for sustainable recovery in Japan, we are only projecting a modest acceleration in Japanese consumption growth from 0.5% in 2003 to 1.8% in 2006. Similarly, our forecast of Euro zone consumption calls for an even more limited acceleration from 1.0% growth in 2003 to just 1.4% by 2006. By contrast, over the near term, the cyclical downside from America's consumption trend-line of 3.75% growth is likely to be larger than the upside from the roughly 1% consumption growth path of Europe and Japan. Meanwhile, all consumers -- except, of course, those in oil-producing nations -- will be hit by the energy shock of 2005.

Alternatively, maybe Chinese exporters could penetrate new markets. In this instance, I think it's wishful thinking to believe that China can simply push a button and redirect the focus of its export machine. This year, the US will probably account for 35-40% of total Chinese exports. Implicit in this extraordinary degree of dependence is a well-established distribution and logistical support infrastructure to US-Chinese trade flows. If the American consumer falters, China doesn't just switch markets overnight. This may also explain why Chinese officials have been so reluctant to utilize their new flexible foreign exchange mechanism to engineer a stronger renminbi. Fearful of slippage in US demand and mindful of the stickiness of export distribution channels, currency appreciation would create export headwinds for China at precisely the moment its unbalanced economy can least afford to face them. At the same time, China's export explosion is now encountering political resistance in major parts of the developed world -- underscoring a potential protectionist backlash to export diversification.

In the end, it may all hinge on the stability of a two-engine 747. The supply engine is going at full throttle while the demand engine is at risk of sputtering. An unbalanced global economy has long been lacking the internal stabilizers to cope with such a mismatch between supply and demand. As long as the American consumer keeps spending, this enormous airplane will keep flying. However, the energy shock of 2005 and the likely end of America's housing bubble draw that key presumption into serious question. The supply engine will have a tough time keeping the 747 aloft if the demand engine runs out of fuel.

Investors need to pay greater attention to the downside risks to global growth in 2006. Such an outcome will put pressure on the earnings underpinnings of equity markets, provide support to bonds by drawing inflation worries into question, and pose a serious challenge for dollar bulls. The 747 is about to enter turbulent skies.

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