THE BROOKINGS INSTITUTION

GLOBAL ECONOMY AND DEVELOPMENT PROGRAM

Inaugural Global Agenda Forum

Panel: The State of the Global Economy

Featuring:

Kenneth Rogoff, Visiting Fellow, Brookings

Stephen S. Roach, Chief Economist, Morgan Stanley

Moderated by Zanny Minton Beddoes, U.S. Economics Editor, *The Economist*

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MS. MINTON BEDDOES: Thank you very much.

Welcome to this first session of the afternoon where we are going to look at the state of the global economy and look at the year ahead. We are actually going to do several things in the next hour and a quarter. First of all, Lars Thunell, the Executive Vice President of the IFC, will kick off our discussion with some remarks about the IFC and its role in emerging markets. Once we have had that discussion, we will broaden it into a broader discussion between Ken Rogoff and Steve Roach here in the middle, and I hope then we will broaden it to questions from all of you as well, and we will discuss the results of the poll we have just taken. So we have got a lot to do in the next hour and a quarter.

That is why I am going to rather rudely go only very briefly over the distinguished bios of our panelists. You have their full bios, I think, in your packets.

On Steve’s right, my immediate left, is Ken Rogoff, only moderately less gloomy, I would say. Ken is now here at Brookings, having been Chief Economist at the International Monetary Fund and, of course, a professor at Harvard University. Steve, actually, I may add, I didn’t realize he was at Brookings also. Four decades ago, isn’t that right, as a research fellow?

MR. ROACH: Yes.

MS. MINTON BEDDOES: So there are strong Brookings' selections here.

MR. ROACH: That is when I first figured out the world was going to come to an end.

MS. MINTON BEDDOES: Without further adieu, Mr. Thunell, would you like to start our discussion?

[Note: See transcript "Emerging No More" for specific comments and relevant Q&A with Mr. Thunell.]

MS. MINTON BEDDOES: Now, Steve, 29 percent say more spending on social insurance and 17 percent, freeze on FTAs, and 4 percent, protection. Now this admittedly is not a representative audience of Americans, but that said, you said in your remarks, and I can't remember the exact wording you used, but is globalization is in big trouble or something along those lines. I took it to mean that the political backlash was gaining steam, you thought. How do you think that political backlash is really going to manifest itself?

We hear a lot of rumblings about anti-China, protectionism, particularly against China. Do you really think the risk of that has risen?

MR. ROACH: Absolutely, I mean in the last two years, Zanny, when the Republicans were in charge of the U.S. Congress. You remember the Republicans, right?

MS. MINTON BEDDOES: I remember them.

MR. ROACH: During that period, there were 27 different pieces of anti-China legislation that were introduced in the U.S. Congress. None of them were passed, but they certainly were going after the issue. The bills, as evidenced by Schumer-Graham, had bipartisan support. The Democrats are in charge now and, if anything, the momentum is picking up.

Schumer and Graham have withdrawn their bill because it obviously was not WTO-compliant. In my discussions with them and their staff and other members of the Senate, it is very clear to me that Schumer and Graham are going to get together with Max Baucus and Chuck Grassley, the two ranking members of Senate Finance, and they are going to introduce a very comprehensive new trade bill, probably in the first half of this year. If they find that a country is running a large bilateral trade imbalance with the US because of a “misaligned” currency, there will be automatic sanctions imposed upon that country. They have China in their cross-hairs.

The final thing I would say here is that in the last few years, the impetus on trade frictions and China-bashing in particular has come from the Senate, the more staid, deliberate chamber of our legislature. I suspect over this year and next year that the dynamic is going to shift to the House. I challenge you to give me one example of a free trade advocate in a leadership position in the current US House of Representatives. They are missing in action.

MS. MINTON BEDDOES: They are hard to come by.

I want to open the floor to questions in a second, but can I just push back against the two of you by saying that I wasn't here in the 1980s, but I understand that in the mid-1980s, the anti-Japanese protectionist sentiment was at least as bad, and in 1984 there were over 100 anti-Japan protectionist pieces of legislation in the House. When you look back now, yes, sure, there was some protectionist legislation passed, but it wasn't anything too terrible. The world did not go back into the days of Smoot-Hawley.

Now, if anything, the global economy, as you have both pointed out, is more integrated, much more integrated in a kind of very fundamental way than it was two decades ago due to technology as well as globalization. Doesn't that make it much harder to see really dangerous protectionist backsliding?

MR. ROGOFF: I broadly agree with Steve on this. I don't think anything will actually happen until his other prediction is true, which is that we will have a downturn, which someday we will. Then we will be much more vulnerable to a protectionist backlash. When unemployment is rising and people are seeing their houses fall in value and they might start panicking. Then we are more vulnerable.

Importantly, we haven't seen a really dramatic downturn over that period that you mentioned. True, with Japan, we did have the Plaza Agreement and the Louvre Accord. The US has not managed a similar agreement with China yet. I think if we could achieve something like that, some of this short-term pressure would go away.

On the other hand, the statistics on inequality seems to show it has really jumped up the last 20 years, with the top echelons really pulling away from the rest. In that sense, the system is already vulnerable.

There is no question that in the last election, a lot of fire-breathing protectionists got sent to Washington. I suspect that Senators Schumer and Graham feel middle of the road now. When people see there is political capital there and when we have a downturn so that the public is looking for a scapegoat, we could see something. It won't be Smoot-Hawley, but it can be unstable if the U.S. does something stupid. Then there is the risk that China will then react, possibly doing something stupid, too. Europe is always prepared to do something stupid on trade.

MS. MINTON BEDDOES: That, I would argue with.

MR. ROACH: Let me just make one additional point. First of all, Ken is entirely right on the increase in income inequality today versus the Japan-bashing of the mid to late eighties. The second thing I would add is that if you look at labor shares and capital shares of national income, back in the late 1980s, both labor and capital were under pressure. Many a corporate icon in the United States was really, really feeling the onslaught of Japanese and German competition in a dramatic fashion. So, capital and labor were in the boat together.

This time, it is just labor. Capital has got the highest return in modern post-World War II history. Labor is isolated – making it a much more powerful political force in driving the China-bashing today than was evident back then.

MR. ROGOFF: I have to say, parenthetically, I walked down the street a little earlier today, and there was a little union protest going on. I couldn’t help but thinking “Oh, that is quaint.” But if things keep going the way they are, this could change. Unions may make a comeback.

MS. MINTON BEDDOES: We could have this debate for a long time. We need to open the floor to questions.

Yes, the gentleman there.

QUESTIONER: I had the good fortune of serving for six years on the U.S.-China Economic and Security Review Commission which was a special commission set up by the Congress to look at China, but as you look at China, you understand it is part of the larger globalization phenomenon, and I couldn't quite figure. Steve Roach really helped me understand what is going on when he coined the term, global labor arbitrage. This is quite different than trade as traditionally understood.

If you look at Steve's charts, look at chart number five on page five. China's exports, since getting into the WTO, they have gone almost straight up. That is because instead of worrying about maybe a 42 percent tariff coming into the United States, we have an average tariff on Chinese goods coming in here of 2.5 percent. People are moving capital. About 60 percent of China's exports are foreign invested companies. So you have got to understand that.

The second thing and the curious thing I am wondering here, look at page number six. The personal consumption as a share of GDP in China, it has fallen dramatically since China has gone into the WTO. What? I don't quite understand that one, Steve.

And let me tell you the other thing I always get worried about is when people come to these conferences and they start saying people are unhappy like we filed the WTO case against China and their subsidies. One of the speakers earlier said that was protectionist. Well, asking China to live up to its WTO responsibility doesn't seem protectionist to me. Everybody understands China is deliberately under-pricing its currency. I don't understand why people say it is protectionist if Americans say something should be done about that.

I think you have to understand -- I served 15 years on the Senate Banking Committee staff -- what is going on here. The politicians are trying to understand what is happening here to the average American, and I don't think it is good for them.

These are some of the trends that I was very interested in, the fact that China's own personal consumption as a share of GDP has fallen dramatically since they came into the WTO.

MS. MINTON BEDDOES: Steve, maybe you could comment?

MR. ROACH: Sure. I definitely remember your commission. I remember making the mistake of trying to defend China in front of your commission and being labeled by one of your commission members as a "panda hugger."

QUESTIONER: It wasn't me.

MR. ROACH: Then I remember going to Beijing a few weeks later, and on my bed in the hotel was a huge stuffed panda bear.

Look, consumption in China is growing rapidly, but it is obviously not growing as rapidly as the rest of the economy, especially investment in plant and equipment and exports which over the past five years have grown, on average, by close to 25 percent. Now China knows full well that you can’t drive a sustainable economic development model for an indefinite period of time by just focusing on investment in exports. On the investment side, they are close to 50 percent of GDP right now. It is a recipe for excess capacity and eventually deflation. On the export side, the type of protectionist discussions we are having become more and more intense. So they have got to balance it out by shifting to private consumption. But you don’t just push the consumption button.

Lacking in China is a safety net -- social security, unemployment insurance, pensions -- that gives Chinese consumers the confidence in job and income security and will enable them to draw down a high level of “precautionary saving.” They are nowhere on the safety net. They are focusing on it now for the first time. China’s newly enacted 11th Five-Year Plan put in place just about a year ago is very much focused on beginning the process of building a safety net. They will do that. I think the Chinese, when they put their mind to it, can do anything. But they are starting from ground zero. It is going to take three years, five years, and some would say even longer than that, to really give the Chinese consumer the confidence to begin stepping up and drawing down excess saving.

MS. MINTON BEDDOES: Steve, you didn't mention the currency in that response.

Ken, maybe I can talk to you because this is the big question here in town. What role does the currency lay in that?

MR. ROGOFF: I don't think the currency plays such a huge role, and I think if they were go to a more flexible exchange rate, it would let a lot of steam off in the system. A more flexible currency would also slightly shrink China's trade surplus and, more importantly, make Chinese less vulnerable to crises, make the global system less vulnerable to crises. It is not a panacea. Remember that Japan allowed its currency to appreciate a few hundred percent since 1970, but throughout they still ran a giant surplus. So will China. Currency flexibility is not the fundamental issue.

MS. MINTON BEDDOES: There is a question from the gentleman over there. Would you mind identifying yourself?

QUESTIONER: Bill Lane with Caterpillar.

First of all, I found the conversation fascinating. I am always sort of befuddled a little bit when I come to a place where you have the world's best economists and we have mercantilistic discussion about the global economy.

My question is really two parts. One is the last three or four years have been the strongest for worldwide global economic growth since World War II. Do people know that and how does that play politically? The U.S. and China have been big beneficiaries, but also the developing world has been a huge beneficiary over the last couple of years.

Then secondly, we just hosted President Bush in Peoria, Illinois, where he talked free trade, not fair trade, free trade before a UAW audience and got a very warm response. I guess my point is probably the biggest free trader in the Administration is President Bush. The biggest free trader in the Senate, I would say is Chuck Hagel. In the House, I think there is a couple that could vie for that, but I agree with you that some of the most prominent ones are not wearing it on their sleeve like they used to.

Just overall, strong economic growth, what is that attributed to and do people get credit for it?

MS. MINTON BEDDOES: Ken, maybe you should start.

MR. ROGOFF: It is not the strongest period for the G-7 since World War II.

QUESTIONER: Since World War I.

MR. ROGOFF: What has really happened is we are seeing growth in parts of the world that we haven't. Again, not to be a pointy-headed economist, but it is hard to compare global growth today with decades ago because the growth is centered in very different regions, and there are all sorts of accounting and index problems making hard comparisons. Overall, today is a good period. There is no question about it.

Still, it is reasonable that people have a lot of anxiety in a period of rapid change. It is just not the case that everybody wins, period. There have definitely been losers. I grew up in Rochester, New York, and Rochester, New York, has just been gutted basically over the last 40 years. My mother is still there. I go back there a lot. If you are stuck there, somehow it isn't so great. If you come from Senator Graham's part of the world, it is easy to find many firms that have closed and workers who have lost their jobs.

I think the larger effect is that although the majority of people are doing better than twenty years ago, they are not doing all that much better. They sort of feel poor when they look around them. That is probably the most dramatic kind of stress that people face, and it is very real. You say, well, you shouldn't care that your neighbor has gotten five times richer and you have gotten five percent richer. You shouldn't care, but that is the way we are wired.

MS. MINTON BEDDOES: The gentleman there.

QUESTIONER: Let me go back to the question of natural resources in Africa and make a number of points. First, I think we should recognize that tariff escalation in China is much worse than it is in the E.U. or the U.S. Processing of anything is just forbidden practically by the levels of tariff escalation.

You also have a situation in which I think a country like Chile shows us that you can have 20, 25 years of 6 percent growth without being a manufacturing exporter but without also just exporting raw natural resources.

I think there is a lesson there for African countries, and I think to think of them as just exporting the raw product rather than to do as South Africa is doing now. South Africa is, I think, perhaps the only African country so far that has a China policy in the sense that there are now voluntary restraints on textile exports from China to South Africa. South Africa is investing in coal to liquid technology and so on in China.

I think African countries need a China policy. I think processing of natural resources and getting much more in the way of spillovers from Chinese investments in African countries is an important agenda. We shouldn’t just think of

African countries as just there to export natural resources in their raw form.

MS. MINTON BEDDOES: Steve, do you have comment?

MR. ROACH: Not really. I agree with the comment.

MS. MINTON BEDDOES: Any more questions?

Yes, over there.

QUESTIONER: In the chart that was shown on labor and capital shares, I was struck by the fact that you don’t get a systematic change over time. Labor shares in the G-7 seem to have been improving up until 2001, and then they turned south and vice versa for capital shares. So, in 2001, you can say that is when China entered the WTO, but 2001, I think also had some non-economic events that might have changed labor and capital shares. I am wondering if either of you would like to comment on whether these are long-term global trends from globalization technology or whether these are also affected by domestic policies in the G-7.

MR. ROACH: As Ken indicated in his comments, we don’t know. I mean there is an interplay of a lot of forces that shape the distribution of income between labor and capital. We can hypothesize. I have seen empirical studies that have demonstrated with powerful statistical tools, a very ambiguous result. It is just not clear whether it is technology, globalization or other factors at work.

The one thing I would say, and Ken alluded to this, is the thing that is so striking about this globalization is that it is an IT-enabled globalization. The pressures of such a process go much deeper into once non-tradable services because of IT-enabled connectivity that allowed the white collar knowledge worker located in Bangalore or Shanghai, Eastern and Central Europe to deliver intangible information-based output from anywhere in the world. Now that is a very different type of phenomenon.

There is cyclicality to these shares that you alluded to — they go up, they go down. The point to make about the chart that you were looking at -- and this is true not just of the G-7 aggregate that I showed but of the individual economies, especially the United States -- is the share going to capital in the United States, the profit share of U.S. GDP, has never been higher during any other up cycle in the modern, post-World War II era. So this is as good as it has ever been for the owners of capital and for the wealthy individuals who play a disproportionate share in owning that capital.

The labor share has been at this level only once before, but this is sort of a tie for the all time low of the labor share in the modern day, post-World War II era.

Even by looking through the various cycles, and you are right to point that out, these are extreme observations on both counts. I think that is an important piece of the response that we are seeing now playing out in the political arena just down the street here.

QUESTIONER: Colin Bradford, Brookings.

I think it is not a good idea to let Steve Roach out of the room without asking him whether looking at his two scenarios on page 14 and knowing you as being something of a gloom-sayer -- would that be the right word -- what do you see, looking ahead, in terms of not only the U.S. economy but also particularly the global imbalances and the other factors in the world economy, whether you see a soft landing or a hard landing. Hard landing seems implied very definitely in the second of these two columns.

MR. ROACH: Well, first of all, I will have to defend myself here. I am optimistic on China. I am optimistic on India. I am very optimistic on Germany these days. I have even said a few good things about Japan. I am only a pessimist on one economy, and that is the U.S. And so, my reputation as a perennial doomster and gloomster is all Zanny’s fault. Whenever she writes about me, I am Wall Street’s perennial doomster.

MR. ROGOFF: I will second this. I have been on panels with Steve when I was more negative about China by a good margin than he was.

MR. ROACH: There you go. But, no, I don't mean to blame the moderator.

MS. MINTON BEDDOES: That is okay. Don't worry.

MR. ROACH: Look, the scenarios that I laid out — the globalization scenario or the more friction-driven localization scenario — they are really meant to point out some strikingly different implications for world financial markets. One (globalization) is very positive, and we are living it right now. This is as good as it gets. The other (localization) is very negative.

The future is not going to be black or white. My guess is you will see a shift from the pure globalization play of today toward more of a friction-driven localization scenario over the next few years. I think that is a real warning for financial markets.

As I travel around the world and meet with investors on a regular basis, the one view that they are strongest on is that there is basically a zero chance that the world will move away from trade liberalization and embrace trade frictions or protectionism. Investors do not want to believe that. They are playing the emerging markets because of that belief. They are playing the BRICs. Look at the spreads in emerging markets. As if globalization is a God-given right and nothing will stop it, such enthusiasm is now in the price of these securities.

If the pendulum of political power begins to draw this into question, I think there are some legitimate risks to think about for world financial markets. That is the point of those two columns.

MS. MINTON BEDDOES: There was one question here.

QUESTIONER: I just wanted to add a thought about what Steve was talking about everybody wants to be a manufacturer. Part of what you have to understand in the political problem here is the thought is if you want to be a major geopolitical player in the world, you have to have a pretty good manufacturing and technology base. The current trends are changing, dramatically, some of those positions in the world. So it is not just an economic issue that is driving the concern. It is also people talking about, and Senator Dodd has talked about, the decline of our defense industrial base. These are some of the things that are going on in the Congress, not just the trade issue. It is a larger phenomenon.

The other point I want to make is I think Ken talked about Japan that was both labor and capital lined up and now there is a divergence of interests, but the problem is not just labor alone here now. The fact that, as Steve talked about, so many jobs can be outsourced through the Internet, the white collar guys are joining with labor, traditional labor to drive the political concerns in this country.

I think to understand the politics of it, that is my take on what is going on.

MS. MINTON BEDDOES: Maybe in conclusion, you could give us some sense -- I am not going to brand you a gloomster anymore -- how you see the next, let us take a four-year horizon? That takes us beyond 2008. How will these concerns play out, firstly?

Secondly, what is the likely policy response? We talk about the risk of protectionism. Are there actually likely alternative policy responses and, as a result, how gloomy or otherwise should be?

Ken, maybe we will start with you.

MR. ROGOFF: You are talking about four years. I think there is an, I don't know, 80 or 85 percent chance of a huge hit at some point that either comes from China, geopolitical, but I would say there is a very high chance of a major global recession within that period, maybe towards this end, not so much this year but within that period.

I think there are reasons, and Steve has outlined some of them, to believe that the recession will be deeper this time. We have really had two very mild ones in 1991 and 2001, and 1983 was the last serious one. But some of these imbalances and excesses that have built up are really quite striking compared to where we were, and so we are quite vulnerable.

Yes, we could keep growing for 25 more years and have the longest period in the history of the world where nothing bad happened, but I think four years is a long time to keep the ride that we have been having.

MS. MINTON BEDDOES: Steve?

MR. ROACH: Well, I am a big believer, Zanny, just to pick up on Ken's point, that the disparities between current account and deficits and surpluses, saving and lack of saving across the world, are greater than we have seen in the modern day world economy. Nor do I believe for a second that imbalances are sustainable. So I do believe that over this next 3-4 years, there will be a significant rebalancing of the global economy.

The question that you are asking, and I don't want to duck it, is whether the rebalancing will be benign or malign. We all want the benign rebalancing. Such a "rosy scenario" will be defined by increased saving in the U.S. while the rest of the world, the big savers, will begin to spend a little bit more. I think that is wishful thinking. It is a great script for a nice soft, squishy soap opera, but we are talking about labor and capital battling for shares in a very dynamic and highly competitive global economy. We have a lot of economies that are significantly overweight in dollar-based assets in their reserve portfolios who are now getting attacked by U.S. politicians. Why should they keep their reserves in dollars?

You have got a pretty combustible pile of kindling wood. It would not take much to ignite this wood pile. Whether it comes from a sharp decline in the dollar, a geopolitical event, a domestic political disturbance in the U.S., I don’t know. But I do worry that the current state of imbalance in the global economy sets us up for a more disruptive rebalancing along the lines of which Ken alluded to.

MS. MINTON BEDDOES: On that very positive note, thank you both very much.