America can no longer propel the global economy. Unless other countries take over, argues Zanny Minton Beddoes, the economic outlook is grim and globalisation is at risk

The evidence is still tentative, but America's economy seems to be gaining momentum. Consumers have stepped up their spending; the housing market is still sizzling; even manufacturing is perking up. For months, Wall Street's number-crunchers have predicted that America's real GDP growth will reach more than 4% in the second half of this year. That figure now looks more like a forecast and less like wishful thinking.

As the signs of an upturn accumulate, the relief abroad is palpable. From Mexico to Malaysia, the world is looking to America to lead a global economic rebound. In its latest projections, published on September 18th, the International Monetary Fund puts the growth in global GDP next year at 4.1%. But excessive reliance on America is also the biggest problem facing the global economy today. As Lawrence Summers, Treasury secretary under Bill Clinton, once put it: “The world economy is flying on one engine.”

The statistics are startling. Since 1995 almost 60% of the cumulative growth in world output has come from America, nearly twice America's share of world GDP (see chart 1). America's disproportionate contribution to global growth reflects an extraordinary rise in American spending. Domestic demand in America has risen, on average, by 3.7% a year since 1995, twice the pace of the rest of the rich world.

Just as flying on one engine is inherently risky, so a one-engined
world economy is more likely to crash. Global prosperity depends overwhelmingly on American demand. If it were to drop significantly, the world would tumble into recession. Yet for years Americans have been spending far beyond their means.

America's national saving rate is at an all-time low. The country's current-account deficit—in effect, the amount it must borrow annually from foreigners to spend more than it produces—has been rising fast, and is now running at over 5% of GDP, a historic high (see chart 2). As a result, the United States, which as recently as 1980 was the world's biggest creditor country, has now become the world's biggest debtor country.

This survey will argue that the world cannot continue indefinitely to rely on American spending. The chances are that Americans themselves, weighed down by the burden of high debts, will eventually start to save more. But even if they do not, foreigners will become increasingly unwilling to fund American spending.

During the 1990s boom, it was American firms that powered the global economy with a huge debt-financed investment spree. But after the stockmarket crashed in 2000, investment spending collapsed as firms tried to strengthen their balance sheets. Total spending has kept going in part because American households have yet to make that adjustment. They, too, spent beyond their means during the 1990s bubble but carried on after the bubble burst, thanks to sharp cuts in interest rates that allowed them to borrow against their homes. American consumers' indebtedness is currently growing twice as fast as their incomes.

Increasingly, America's spending has also been fuelled by the government. The federal budget has shifted from a surplus of over 2% of GDP in 2000 to a deficit of over 4% of GDP this year. But ever bigger budget deficits will not be able to compensate forever if private spending flags.

Moreover, borrowing from abroad at an accelerating rate can go on only for so long. Eventually the interest on the debt will become too onerous. Long before then, however, foreigners will become reluctant to provide the necessary capital. Already the share of America's current-account deficit that is funded by private foreign investors has fallen. It is Asia's central banks—mainly Japan's and China's—that are picking up an ever bigger share of the tab by buying huge quantities of American government bonds.

Their motivation is not altruistic. By piling into American bonds, Asia's central banks keep their currencies weak, supporting Asia's exports to America. But America's growing trade deficits are now causing protectionist pressures at home, particularly against China.

In the past three years almost 3m jobs have been lost in American manufacturing, one out of six in that sector. With a presidential election due in 2004, demands for action against China are multiplying. Either Asia's currencies will have to adjust, or America will retreat from free trade. On both political and economic grounds, it seems, the world's reliance on one engine is reaching its limit.

**Low on fuel**

But how can the world be weaned off its over-reliance on American spending without sending the global economy into recession? In theory, the route to a more balanced world is clear. Americans must spend less
and/or foreigners must spend more and/or the dollar must fall (because a cheaper dollar shifts Americans' spending away from imports and boosts exports). Ideally, most of the adjustment should come from higher spending by foreigners. If other countries revved up their economies, they would suck in more American imports. That would allow America's current-account deficit to fall without causing the world economy to suffer.

It has been done before. In the early 1980s, when Ronald Reagan was president, America also borrowed furiously from foreigners, pushing up the current-account deficit to over 3% of GDP. In the later part of the decade, that deficit came down again without causing a global recession, thanks to a big but controlled drop in the dollar and especially to booming economies in Germany and Japan.

Can history repeat itself? If today's current-account deficit could be painlessly reduced, just as it was in the 1980s, the one-engined world might not be such a problem. But the chances of a repeat performance are slim. The imbalances are much bigger and more entrenched, and the world economy as a whole is both more fragile and more complex. There are no other obvious engines, and there is no easy way to get the dollar down.

Given their economic size, the euro zone, especially Germany, and Japan remain the most likely back-up motors for the global economy. But these economies are in a mess. Both regions are having to cope with a worrying combination of ageing populations (which tend to dampen spending) and structural rigidities (which slow down growth). In recent years, both have also suffered from extraordinarily incompetent macroeconomic policies.

Japan, the world's second-largest economy, has had an abysmal decade of deflation and stagnation, brought on by its government's inability to deal with the aftermath of its own asset bubble in the 1980s. In Europe, an obsession with tight macroeconomic policy has exacerbated the recent economic downturn.

There are some signs of change. In Germany, especially, there is now a recognition that the overtaxed and over-regulated economy has to be reformed. In Japan, the economy is perking up and there are glimmers of evidence that policymakers are at last grasping the need to reform. But both Europe and Japan have a long way to go before they can provide any back-up.

**A less mighty dollar**

With no alternative engines ready to kick in, the dollar will have to play an even more important role in America's adjustment than it did in the 1980s, when it fell by 55% against the D-mark and 56% against the yen. Since its peak in 2002, the dollar has already fallen by a total of 8% against its trading partners. But that is nowhere near enough.

Many economists reckon that, in the absence of a shift in global demand patterns, it would need to fall by 40% or more to make a serious dent in America's current-account deficit. That kind of depreciation is hugely risky. The more a currency falls, the greater the danger that it will fall too far, too fast. A sudden dollar crash could roil financial markets and plunge the world into recession.

Moreover, the dollar is unlikely to fall evenly against other currencies. The Asian central banks' determination to stop their currencies rising has, so far, concentrated the dollar's fall on the euro, with a 20% drop against the European currency since early 2002 compared with 8% overall. A further, even bigger drop in the dollar, targeted on the euro, would probably sink Europe's economies.

To spread the burden of a dollar drop more evenly, Asia's currencies too must appreciate. But that will not be easy either. In Japan—which has the world's biggest savings surplus and intervenes most actively to
hold down its exchange rate—a dearer yen would lower import prices and further aggravate the economy's deflationary crisis.

Even in China, the case for a stronger yuan is not clear-cut. Unlike Japan, China is not running a big trade surplus. Its economy, despite rapid growth, is fragile; the banking system is bust. A sudden jump in the currency could cause the financial system to collapse, eliminating one of the few bright spots in the world economy.

With so many imbalances, and no easy adjustments in sight, the global economy is clearly in trouble. Stephen Roach, chief economist at Morgan Stanley (admittedly one of the most pessimistic seers on Wall Street), claims the world faces “its toughest array of macro problems since the end of the second world war”.

The risks of a dollar crash or a serious global recession are not insignificant, and a period of sluggish growth and currency volatility seems all too likely. The 1930s offer a lesson in how protectionism can flourish when economies are in recession and exchange rates tumble. For the past few years, politicians have done little more than hope that the American engine carries on working. But this is no longer good enough. Policymakers need to act to make a crash less likely and avert protectionist threats. A good first step would be to acknowledge the size of the problem.