

HIGH STAKES

**What lies ahead for the global economy?
Does the United States need help to recover?
A Symposium hosted by The Japan Society**

**Westin Harbour Castle Convention Centre, Toronto
Tuesday, March 24, 2009, 8:00 am – 2:00 pm**

ABSTRACT

Agenda

- 8:00 – 8:45 Breakfast
- 8:45 – 8:50 Welcome and introduction
Ben Ciprietti
- 8:50 – 9:00 Moderator's remarks
Don Newman
- 9:00 – 9:45 Overview: Getting the context and diagnosis right
William A. Macdonald
- 9:45 – 10:30 Lessons from Japan and what Asia can do
Richard Koo
- 10:30 – 10:50 Coffee break
- 10:50 – 11:35 The pathway to recovery and a more functional global
economic order and financial system
Martin Wolf
- 11:35 – 12:10 Discussion from the floor
- 12:10 – 12:30 Pre-lunch beverages
- 12:30 – 1:15 Lunch
- 1:15 – 2:00 The role of other countries
David Dodge

Japan Society hosts leading edge forum on global economic change

The road out of economic recession will be deep and long. The United States alone is not responsible, nor is it able to lead the world out of recession on its own. Collective action and new political will for difficult choices will be required to achieve major restructuring of 20th century economic models. These were the overarching messages arising from the symposium “High Stakes: What Lies Ahead for the Global Economy? Does the United States Need Help to Recover?”

On March 24, Canadian business, academic and government leaders met in Toronto to hear four of the world’s most respected economists and public policy thinkers discuss the deep economic downturn and the underlying forces which will prevent recovery unless large-scale, new actions are taken on the part of governments around the globe.

Hosted by the Japan Society of Toronto, the symposium featured veteran CBC journalist **Don Newman** as moderator. Guest speakers were **William A. Macdonald**, strategy and public policy consultant; **Richard Koo**, Chief Economist for Nomura Research Institute in Tokyo; **Martin Wolf**, Chief Economic Commentator for the *Financial Times*; and **David Dodge**, former Governor of the Bank of Canada.

The financial meltdown in the fall of 2008 is only a symptom of a larger dysfunctional global system in which chronic trade imbalances between countries prevent healthy, self-sustaining global economic growth. Without new thinking about our global system, according to all presenters at the symposium, the world will not resume a growth path and, in fact, will get worse.

There were **two important sub-themes** which emerged through the day. The first was that **without collective action from the world’s leading economies, the required changes will not occur**. The United States and other countries need to work together to develop solutions. The second message was that **Japan can play a role as teacher**. Japan’s so-called lost decade of recession through the 1990s began under the same conditions as the current global recession. Learning from Japan’s experience and its government response over the past 15 years can help soften the recession’s impact, might shorten its length and will improve its outcome.

Recession requires wartime response

The tone of the day was heavy. In Mr. Macdonald’s opening comments he said, “We have yet to understand, I think, the stakes or to muster the political will to address the very real possibility that not only could the systemic global credit crisis and the spreading U.S. balance sheet recession lead to a lost decade or worse for the global economy. But it could also lead to the breakdown of the globalization project itself, despite the huge net economic benefits it has brought to virtually every corner of the world. This in turn could threaten geopolitical and social stability. That is the fundamental context for the current financial and economic crisis. This is so big that it demands mobilizing the efforts of all the major economies.”

Mr. Macdonald likened today’s economic situation to that of war, requiring the urgent and massive response that a government would give to mount a battle. Both Mr. Koo and Mr. Wolf shared the opinion that urgent, massive effort is required by governments and

international institutions to minimize further damage to individuals and nations, whether first world or emerging, and to set the world up for an era of better balanced, sustainable growth in future. All presenters agreed on the root cause of global economic trouble: chronic trade imbalances; and on the only way out: collective government action to restore balance.

Each presenter had a different focus. Mr. Macdonald gave the overview. In his talk called “Getting the context and diagnosis right,” he described the economy of the last 30 years as a “two-model” system. He said that Japan, when its asset bubble burst in the early 1990s, was the first casualty. “One model was the earn-more-than-you-spend model of Japan, Germany and China. The other was the spend-more-than-you-earn United States and United Kingdom model.”

The two-model system is dying, Mr. Macdonald said. “It is pitifully simple. There can be no export-led models by the world’s large economies when there are no spend-more-than-you-earn large economies to take the exports.” To replace this dying system, new leadership is required on the world stage and Mr. Macdonald called on the President of the United States and the Premier of China to step up to the challenge. Reminding the audience that in previous times (pre-World War I, or post-World War II), no one could imagine the great changes that were to come, we at this time of economic crisis also cannot imagine how history will play out in front of us, Mr. Macdonald said.

In terms of getting the diagnosis right, Mr. Macdonald observed, “There have been many attempts to ‘blame’ one or more countries and sets of economic players – the U.S. for consuming and borrowing too much; China, Japan and Germany for not consuming enough; Wall Street for being too greedy; and so on. There has no doubt been much unaware, inept, unwitting, foolish, corrupt and even criminal behaviour. But none of this would have happened on a dangerous scale if there had not been a failure on the imbalances and in systemic guardianship of the credit system as the circulatory system of the economy.”

After outlining specific recommendations, Mr. Macdonald called for government policy action on “three fronts: stronger demand in the real economy; much improved credit flows; and getting on the path to righting the imbalances. The fact the United States needs help on all three fronts does not mean it is in decline. It means that the success of globalization has produced a new global economy math and that the dysfunctional two-model form of that globalization will be replaced. There will be no happy countries if the U.S. recovery falters. But if it succeeds, it will mean that China has helped make that happen. This would be a transformational moment for the world ... It will be an even better outcome if all the current account surplus countries understand and act on the need for collective action.”

Learning from Japan’s lost decade

Richard Koo, Chief Economist, Nomura Research Institute, in Tokyo followed Mr. Macdonald with a specific and detailed analysis of Japan’s experience of recession the 1990s. In his presentation, Mr. Koo explained the concept of “balance sheet recession,” a term he coined for his book *The Holy Grail of Macroeconomics*. The term has become widely accepted to describe the state faced by companies and households when their

assets, purchased through debt, have lost value, leaving expensive loans on their balance sheets that still need to be repaid. Households or companies focus on debt repayment rather than profit maximization. This restores balance sheets, but takes money out of the economy, resulting in a deflationary spiral. The notion of balance sheet recession explains the Great Depression and Japan's recession after the bursting of its asset bubble in 1990. It also explains the dramatic economic contraction the globe is experiencing now, after financial market meltdown in fall 2008.

Many critics believe Japan performed poorly through the lost decade and therefore the lesson is to not emulate Japan. Mr. Koo countered that Japan's response was actually a good one, and though the economy performed poorly, the fact that its economy did not contract was, itself, a tremendous feat. "The reason you have been bombarded with this argument that fiscal policy never worked well in Japan... the fundamental assumption in those articles is that without that spending, Japan would have grown at zero percent anyway. And against zero percent growth, well, they have very little to show for that 300 trillion yen fiscal stimulus. But when you realize that Japan actually experienced an asset price collapse of 87%, losing wealth equivalent to 3 years of GDP, it's remarkable that our GDP never fell below the peak of the bubble," he said.

"Instead of allowing the situation to fall into deflationary spiral, what the Japanese basically did was to take that money and put it back into the income stream." The only choice for the U.S. government, said Mr. Koo, is to do the politically difficult thing and allow deficits large enough to offset the savings being carried out by households and companies. Monetary policy is ineffective in a balance sheet recession.

Mr. Koo argued strongly for the U.S. to push for continued fiscal stimulus over a sustained period, and to explain the conditions clearly to the American people rather than attempting one-time packages which will never be adequate. Interest rates will not increase because the government replaces former corporate or household borrowers. In fact, government borrowing is an important replacement as companies and households pay off their loans. As the new borrower, government will keep financial institutions and the economic system running. Without it, there will be faster collapse, he said, more job losses and deeper pain.

Restoring global balance, financial market reform

When Mr. Wolf took the podium, he briefly talked about the problems in financial markets with over-borrowing, and the sub-prime market meltdown, but he focused on the larger issue of trade imbalances between countries. "Essentially my proposition is that unless these underlying problems are fixed, which means dealing with the consequences of the credit boom which is, in fact, the balance sheet deflation Richard talked about, and the flow problem, which is the global imbalances ..., we are not going to have a sound recovery... and it can't be done by the U.S. on its own," Mr. Wolf said.

Criticizing international institutions like the World Bank and the International Monetary Fund, Mr. Wolf argued that there were systemic problems which caused emerging economies to become export-driven in order to increase their reserves of U.S. dollars, while the developed countries enjoyed imports but developed chronic trade deficits. A more balanced approach through a reformed IMF would allow developing nations more

security. Without feeling the need to have massive US dollar reserves, they could work at improving domestic demand rather than pushing exports to developed nations.

Using data, Mr. Wolf showed how increased U.S. debt matched increased foreign reserves of trade surplus countries such as Japan, Germany and China and the oil exporting countries. Mr. Wolf decomposed the data on U.S. debt into different sectors, which showed that debt is held by households and government. Corporate debt, except for in the financial sector, is not a problem.

The data showed the parallel increase of debt and house prices. When the housing market collapsed, consumption naturally had to be halted as all cash needed to be directed towards debt repayment. Although consumption of services in the U.S. remains steady, consumption of durable goods has fallen sharply, which is what has pushed recessionary conditions to emerging, export-oriented countries.

Like Mr. Koo, Mr. Wolf concluded that the U.S. must engage in sustained fiscal stimulus to support its own economy, but added a strong call for international financial institutions to be reformed so that emerging economies can develop their domestic markets.

Greater stability in financial markets required

Mr. Dodge's presentation supported the earlier presenters and called for better international oversight of markets and corporate behaviour, more international standards and better government policy and regulation. "While we must seek to reduce global imbalances and the risks inherent the operation of markets, we must also seek to do so in a way that doesn't undermine the economic and social dynamism that markets provide. But we've got to recognize, as was said this morning, that markets don't always get it right. At the macro-level they have been prone to waves of excessive exuberance and despair, and at the micro-level they can fail disastrously due to information asymmetries. And neither households nor firms always act in what might objectively be thought as economically rational manner."

Recapitalizing the banking system is an important priority, said Mr. Dodge, because a healthy economy requires a working financial sector. To do this, banks will have to be allowed wider interest rate spreads so they can write off their non-performing loans. For long term health, they also need more counter-cyclical capital buffers. "The normal operation of banking is such that there will be periods such as the period we had in the early part of this decade, when it appears that the work is terribly profitable. What's not really clear is that risks are being under-estimated at that point in time, and that not enough has been put aside." Changes to regulations and accounting systems need to encourage greater reserves for economic downturns, he said.

Mr. Dodge had several specific recommendations to improve stability in financial markets and institutions, including giving central banks greater authority; greater standardization of derivative and structured products; a change to executive compensation incentives; and the creation of central clearing encounter parties; among others.

Agreeing that the fundamental problem is chronic over-consumption in the U.S. and the U.K., and under-consumption elsewhere, Mr. Dodge acknowledged the difficulties in addressing them. “The incentives are stacked against household spending in much of Asia, just as they are stacked unconscionably in favour of spending in the United States.” However, facilitating the reduction in global imbalances is the most important challenge for regulators.

The most important challenge: reducing global imbalances

Mr. Dodge’s concluding message was as heavy as Mr. Macdonald’s opening:

“Simply let me say that [the problem of imbalances] is the most serious global economic problem that we face. It was the most serious problem five years ago. It remains the most serious problem today.

“We cannot rely forever on the American household to be a consumer of last resort. In the end, effective final consumer demand is going to be required in all countries of the world. Although countries can run current account deficits or surpluses for periods of time, chronic under- or over-consumption eventually requires adjustment and the eventual period of required adjustment is coming.

“America is getting to the point where, as it’s been pointed out earlier, its over-consumption has to be reduced. And if others don’t provide that consumption, the globe will experience chronic demand deficiency, unemployment and slow growth looking out well into the next decade. Global adjustment mechanisms, such as more flexible exchange rates, are important to facilitate this. And we’ll discuss those in international institutions. But the key... is domestic policy. Domestic policy in the United States, and much of Europe which would generate higher levels of saving on the one hand, and domestic policy in much of Asia, Germany and the GCC countries that will in fact stimulate increased consumption.

“Without that rebalancing, we are going to have a very difficult period going forward. Political will to bring those domestic changes about is essential. But I’m just a humble former central banker, so I’ll leave it to others to suggest how such political will might be mustered.”