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The Future of the World Economy

By Robert Samuelson

"The past is a foreign country: they do things differently there."
-- L.P. Hartley, English novelist

WASHINGTON -- It must now be obvious that, economically speaking, we're in another country. Things we once took for granted no longer apply; things we never imagined occur all the time. We've entered a zone of ignorance where familiar experience and ideas count for less. "Thirty years ago, if you'd said that the United States and Europe were going to be the centers of financial crises, people would have thought you were crazy," says economist Fred Bergsten. The unforeseen is now routine.

Profound changes to the global economy contributed to
today's crisis and make it harder to resolve. Bergsten -- director of the influential Peterson Institute for International Economics -- cites three shifts.

First is the rise of "emerging market" countries, led by China, India and Brazil. In 1981, when the Peterson Institute was founded, these nations were laggards. "Now, they're more than half the world economy and are growing three times faster than high-income countries (the United States, Japan and European nations)," Bergsten said in an interview. "They drive the world economy."

Second, the United States has moved from the largest-creditor to the largest-debtor nation. Through the 1970s, the United States generally ran trade surpluses, and U.S. multinational investment abroad overshadowed foreign investment here. But since 1980, U.S. current account deficits exceed $8.5 trillion. (The current account is a broad measure of trade.) And foreigners have invested trillions in U.S. stocks, bonds, factories and real estate.

Finally, financial crises have mushroomed. After World War II, countries restricted the flow of money across borders. This changed in the 1970s and 1980s, when these controls were gradually dismantled. Unexpectedly, rapid inflows and outflows of foreign money caused booms and busts: first in Latin America in the 1980s; then in Asia and Russia in the late 1990s. And the American and European financial crises, though largely homegrown, have had global repercussions.

Globalization, it turns out, is a double-edged sword. It raises living standards by promoting trade and spreading modern technology around the world. But it also causes disruptions and deepens downturns. The future of the world economy hinges heavily on whether this instability is modest and tolerable or massive and intolerable. As Bergsten asks: "Are we on a path not only of crises but also of crises of increasing frequency and rising severity?"

We don't know. What we do know is that mutual dependencies have grown. For years, U.S. trade deficits promoted globalization by boosting other countries' exports. Ideally, emerging-market countries would now return the favor. Their fast economic growth would swell demand for U.S. and European exports, making it easier for these countries to pay their debts and reduce unemployment. The odds of this happening seem no better than 50-50.

What countries see as their narrow self-interest may subvert their collective interest in a stable world economy. Political power has fragmented along with economic power. The currency dispute with China is a case in point. For years, American presidents have failed to persuade China to stop undervaluing its currency and, thereby, subsidizing exports and penalizing imports. Indeed, some economists argue that China's trade surpluses -- converted into dollars and invested in U.S. bonds -- fueled America's financial crisis by driving down interest rates. Low rates then encouraged riskier mortgage loans.

By nature, Bergsten -- who will retire as Peterson's director after a successor is found -- is an optimist. Unlike the 1930s, he argues, we have institutions (the International Monetary Fund, the European Union and others) that allow enough cooperation to avoid disaster. Europe will muddle through its crisis, he argues, because its leaders recognize that the alternatives are grim. Joblessness would surge. Political and social cohesion would collapse. So the European Central Bank (Europe's Federal Reserve) will lend whatever is necessary, and Germany will pay whatever is necessary.

Maybe. Even Bergsten's optimism is tempered. "The next crisis could be a dollar crisis," he warns. Foreigners own roughly $23 trillion in U.S. stocks, bonds, real estate and factories; Americans own about $20 trillion in foreign assets. That's the reality of being the world's largest debtor. A loss of confidence could trigger a sell-off of American stocks and bonds that -- given the dollar's role as global currency -- would reverberate around the world.

Foreign faith in the United States ultimately rests on a belief in America's political stability and economic vitality. Could huge federal budget deficits shake that faith? "The European crisis has shielded us from our follies," Bergsten says. Worried investors have channeled funds from European securities into American bonds, reducing U.S. interest rates and making borrowing easier to cover $1 trillion annual deficits. There's no telling what comes next. We are, after all, in another country.