The world is in a prolonged period of transition, moving from a form of globalization that has proved to be unsustainable to a more robust and balanced model. How long this transition will last is not yet clear, but some of its main features are already evident.
THIS FEEBLE AND VARIEGATED global recovery is a puzzle, throwing up new, unexpected and even contradictory patterns of growth, decline and crisis. Currencies have become as volatile as commodity prices, and gold is hitting record highs. This is no longer a world balanced between stagnant mature economies and surging emergent economies. We now have a G6 recession, in which Germany alone of the traditional industrialized nations is seeing solid, export-led growth.

The banking sectors remain extremely vulnerable to further shocks. Unemployment continues to be stubbornly high, with 30 to 35 million jobs lost since the recession began. In the 35 countries for which statistics exist, more than 40 percent of the unemployed have been jobless for more than a year.

The G20 says the recovery from the world recession is “fragile and uneven.” The Federal Reserve’s Open Market Committee released meeting minutes in July suggesting that the U.S. economy might not regain its “longer-run path” until 2016, which would mean we are just three years into a nine-year recession. The International Monetary Fund (IMF) says, “The global recovery remains fragile…underlying sovereign and banking vulnerabilities remain a significant challenge.” France’s OECD (Organization for Economic Co-operation and Development) thinks the global recovery is peaking and could be poised for a fall. Its latest analysis of CLIs (composite leading indicators) says the trends “reinforce signals of slowing economic expansion” after four successive months of negligible or negative growth. It concludes that “the outlook given by the CLIs for Canada, France, Italy, the United Kingdom, Brazil, China and India points strongly to a downturn.”

Yet corporate profits are remarkably strong, growing in the United States at their fastest pace in 25 years. Despite gargantuan increases in deficit spending and money creation by central banks, inflation remains subdued; this is largely due to high unemployment and low capacity utilization, currently below 75 percent in the United States. Current stock-market values are high by historic standards; the Dow Jones is almost twice as high as it was when Alan Greenspan warned of “irrational exuberance” in December 1996.

How can this be? Logically, considering the traditional patterns of economics, much that is currently taking place in the global economy is counterintuitive and even contradictory. One persuasive explanation, which we at the Global Business Policy Council (GBPC) have been arguing for some time, is that we are in a prolonged period of transition; we’re moving from a form of globalization that proved to be unsustainable to a more robust and balanced model. How long this transition will last is not yet clear, but some of its main features are already evident. These features will help define both the short- and medium-term outlook—and set the stage for the new global economy that will eventually emerge.

**Globalization 3.0**

For the sake of convenience, we need labels for these periods. In this article, we’ll label the time from the end of the American Civil War in 1865 to 1914 as the first period of globalization. The second period took place after World War II, and was hugely dependent on the inventions, vigor and geopolitical predominance of the U.S. economy. It was also dependent on the role of the United States as linchpin and guarantor of the international system, and the readiness of its consumers to go into debt to haul the rest of the world out of its occasional brief recessions.

As the Great Recession took hold in 2008, it seemed likely that the fall in world trade and U.S. imports would end this pattern of world growth driven by U.S. consumption and debt.
This has not happened; the U.S. trade deficit is again running at around $600 billion for 2010. Meanwhile, China and Germany each expect a trade surplus of $200 billion or more, and Japan might reach $100 billion for the year. The pattern of chronic-surplus and chronic-deficit countries has resumed with the recovery, generating ominous political reactions in deficit countries that threaten the global trading system (see figure 1).

We therefore have a paradox: Although the ballooning of global trade imbalances was one of the factors that precipitated the Great Recession, the imbalances have not been corrected. Countries with efficient and productive export sectors—Germany and China, for example—have seen their surpluses as evidence of economic virtue and are reluctant to rein them in. This comes with costs. In Germany’s case, its trade surpluses with its EU partners, particularly those in the weaker southern regions, were a major factor in this year’s euro crisis. Since eurozone members can’t devalue their currencies, they could only have ended their deficits with Germany if an unrealistic surge in their exports or a punitive fall in their demand, or both, had occurred. As a result, Germany reluctantly agreed to the trillion-dollar rescue devised jointly by the EU and the IMF. China has paid in a different way. By holding down consumption to a low 37 percent of GDP in order to subsidize exports and investment, China is deliberately restraining the incomes of its people. In addition, by sitting on a swollen treasure chest of more than $2.5 trillion in foreign currencies and securities—about two-thirds of them denominated in dollars—China is suffering significant losses as the dollar’s value falls.

FIGURE 1

Global imbalances

Notes: CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand; DEU+JPN: Germany and Japan; OCADC: Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey, and United Kingdom; OIL: Oil exporters; ROW: rest of the world; U.S.: United States.
Source: IMF October 2010 World Economic Outlook report
The essential point is that this pattern of trade imbalances is no more sustainable today than it was three years ago. As it wasn’t corrected by the Great Recession, it will eventually be corrected by some other mechanism. Working out these imbalances is a dominant feature of the transition period the world economy is now undergoing.

Debt and Social Costs

The costs of the debt overhang in G7 countries will also dominate this transition period, as these costs are approaching or exceeding 100 percent. Debt levels are currently artificially low thanks to the low interest rates of central banks. It’s uncertain how long these policies can be sustained; at some point, interest rates will rise and the burden of interest payments on government finances will rise with them.

This will be all the more challenging as governments begin to grapple with the mass retirement of the baby-boom generation and all the extra costs of pensions and healthcare that implies. The social contract, as devised by the G7 in the years after 1945, has become unsustainable in its present form. The welfare state costs too much, particularly in Europe, and their economies are no longer producing the growth necessary to sustain it. This problem has been coming for years. Europeans are living so much longer that the pension system is breaking, and governments are facing intense public opposition to reforms, as the recent protests in France demonstrate. Demand for healthcare, similarly driven by the dramatic improvements in life expectancy and the higher health costs of the elderly, has risen to critical levels. Education has also been expanded, but now jostles with pensions and healthcare to maintain its share of national budgets.

Budgets have been under such strain for years, so much so that budget deficits have become the norm across Europe. This “norm” was never sustainable, but the economic crisis has produced fiscal disaster. The traditional Keynesian response of borrowing more money so countries might spend their way out of recession has reached its limit (see sidebar: Buckle Up: This Ride Is Not Over on page 20). The costs of unemployment pay and of bailing out the banks has smashed budgets across Europe and triggered fears of default in Greece, Ireland, Portugal and Spain.

Britain’s Institute for Fiscal Studies has compiled figures that show how Europe’s social democracies got us into this mess. In Britain, for example, they demonstrate that spending on the three major components of social democracy—health, education and social security—has increased tenfold since 1950. That’s tenfold after allowing for inflation. Spending on the national health budget has increased eleven-fold (in the 1950s, it was assumed that the costs of healthcare would decline as people became healthier). By comparison, national income after inflation has increased fourfold. In terms of

The global economy is like a car engine, and three of the main cylinders—the United States, Europe and Japan—are not firing properly and may not fully recover for some years.
national budgeting, the social democracy budget has risen from 11 percent of GDP to 28 percent. Conservative politicians have been unable to prevent this growth. Even under Margaret Thatcher and her conservative successor John Major, it grew from 20 to 23 percent of GDP.

With minor adjustments, these figures have their mirror images across Europe and North America. The United States now spends 18 percent of its GDP on healthcare alone. Although the United States has a higher birth rate and a younger demographic profile than Europe, it faces a similar crisis of public spending (see figure 2). The political chaos and policy stagnation that we see across Europe has its parallels in the Tea Party movement and the anti-immigration clamor in the United States.

**China’s Property Bubble**

The combination of debt and social costs hanging over the G7 economies has daunting implications for emergent countries whose growth strategies depend on exporting to G7 consumers. The IMF has calculated that despite the recovery in world trade, exports are still running at about 25 to 30 percent below trends in both G7 and emergent economies. The appetite of consumers in rich countries for imports is likely to be constrained for some time by the lack of growth in their own economies and the tax burdens their governments will almost certainly have to impose. If Europe, Japan and the United States are not going to be sources of new growth, that puts all the more focus on China.

This is where the concern about China’s property market becomes serious. One way to spot a dangerous real-estate bubble is to calculate the proportion of a country’s total real-estate valuation against its GDP. At the end of 2006, when the U.S. housing bubble peaked, its real-estate valuation had risen to almost double the value of its GDP. Then the bubble burst, starting with the sub-prime mortgage sector, and the consequences of that collapse are still with us. In 1989, when the Japanese property bubble burst, real-estate valuations were much higher, peaking at a staggering 3.5 times

**FIGURE 2**

Projection of old age and health benefits if policies do not change

![Graph showing projections of old age and health benefits](source: A.T. Kearney Global Business Policy Council)
On November 3, the day after the mid-term elections for Congress, the Fed announced that it would buy $600 billion in U.S. Treasury securities during the next nine months and use an expected $300 billion from sales of existing securities to buy yet more. This is likely to represent a bigger injection of money into the financial system than the controversial TARP program launched in the crisis of 2008. The official objective is to force down long-term interest rates to stimulate more investment and growth. Opinions are divided among economists about whether this will work as planned. Some say it will promote inflation, which is all too likely to get out of control. Harvard Professor Martin Feldstein warned in the Financial Times that it was “a dangerous gamble with only a small potential upside benefit and substantial risks of creating asset bubbles that could destabilize the global economy.” He feared that with so little appetite for investment in U.S. businesses, much of the money would leak out to create asset bubbles in emerging markets. Mohamed El-Erian of PIMCO agreed, noting in the FT: “Liquidity injections and financial engineering are insufficient to deal with the challenges that the U.S. faces. Without meaningful structural reforms, part of the Fed's liquidity injection will leak right out of the U.S. and result in yet another surge of capital flows to other countries.”

The Fed could be creating money that American companies neither want nor need. With the recovery so feeble, there’s little demand in the United States for credit and investment finance, so the Fed could now be heading into the liquidity trap defined by John Maynard Keynes as “pushing on a piece of string.” An unspoken further objective of the Fed, however, may be to force down the value of the dollar in international markets to spur U.S. exports and make imports more expensive. In the current feverish international mood, this could be risky policy.

Fed Chairman Ben Bernanke defended his policy in a rare op-ed in The Washington Post: “We have made all necessary preparations, and we are confident that we have the tools to unwind these policies at the appropriate time. The Fed… will take all measures necessary to keep inflation low and stable.” Mr. Bernanke will have to explain himself at much greater length before a new U.S. Congress that already seems committed to subjecting the Fed to unprecedented Congressional scrutiny. The new Congress faces its own challenges, however, because many in the new Republican majority in the House won their primary races in defiance of the Republican establishment. They were backed by the conservative Tea Party movement and don’t think they owe much loyalty to the Congressional leadership, so party discipline will be a problem.

As a result, a serious problem may emerge next June, when the vote looms on whether or not to increase the permitted ceiling of the national debt. When the Democrats voted in January 2010 to raise the debt ceiling from $12.4 trillion to $14.3 trillion, the Republicans ran the issue hard, even though the bulk of the new debt had been generated during the Bush years. Governor Rick Perry of Texas made it a pillar of his re-election campaign and the Tea Party never tired of citing the figure. Now the Republicans are in the hot seat. Some of them, such as Utah Senator Mike Lee and Kentucky Senator Rand Paul, campaigned on a pledge to vote against any further increase in the debt. Congressman Eric Cantor of Virginia (formerly the party whip and now the majority leader) is promising a straight up or down vote, and most likely is hoping his party has by then established some staunch anti-debt credentials.

Congress may not have much choice. If the ceiling isn’t raised, the markets are likely to react strongly to the prospect that the United States won’t necessarily be able to pay back its debts. Next year’s budget deficit is going to be more than $1 trillion, and may stretch way beyond that amount considering what unemployment is doing to tax revenues. President Obama’s own budget projects the debt will increase $4.7 trillion between 2010 and 2015.
the value of Japan’s GDP. In China today, total real-estate valuations are 3.3 times GDP.

This is worrying enough, which is why the Beijing government has been trying to cool the overheated market by ordering that bank loans be scaled back. One recent signal from Beijing is startling. The China Banking Regulatory Commission (CBRC) publicly warned the country’s banks late in July to “deepen” their stress tests on how the banks would handle a property crash. It has since emerged that Commission Chairman Liu Mingkang told the banks to stress test their resilience in the face of a 60 percent drop in property prices. Moreover, he asked them to factor in the prospect of bad loans in the industrial sectors that have done well from the construction boom, such as steel and cement, furnishings, and kitchen and bathroom fittings. That is doubtless a worst-case scenario. Previous stress tests had assumed only a 30 percent fall in the property market.

The threat of a property bust is particularly more serious because China is about to hit a demographic problem. The number of young people entering the labor market peaked two years ago and is now heading slowly but steadily downward, as the number of Chinese pensioners is starting to rise.

If China’s property bubble bursts, it will hurt for a year or two, but the country will recover. The economy will never be the same, however, because there’s no endless supply of new workers to keep wages and prices down.

**Who Will Lead Future Growth?**

The GBPC often uses the metaphor of the global economy as a car engine, and three of the main cylinders—the United States, Europe and Japan—are not firing properly. They may not fully recover for some years, while China and India continue to fire strongly (see figure 3).

**FIGURE 3**

China and India will outpace G20 advanced economies

![Projected average annual GDP growth rate (2009-2050)](chart.png)

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<tr>
<th>G20 advanced economies</th>
<th>BRICs</th>
<th>Non-BRIC developing G20 economies</th>
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1Export-dependent economies will be at a disadvantage as the balance of world trade shifts from developed to emerging markets

Source: Carnegie Endowment
Other emergent economies could help boost world growth. Brazil, Russia, India and Mexico had a combined GDP in 2009 of $4.9 trillion (roughly the equivalent of China’s), but each of these countries faces challenges that are likely to restrain growth.

A number of medium-sized and smaller economies, including South Korea, Turkey, Indonesia, Australia, Taiwan, Thailand, Chile and Malaysia, are growing healthily, and with the exception of South Korea have a demographic profile that promises many years of growth to come.

The sheer momentum of growth in emerging markets provides several reasons for optimism about the future of the global economy. In China, India and much of the rest of the developing world, hundreds of millions of people have already crossed the threshold to become members of the consumer society. The rule of thumb used to define this threshold is a household income higher than $10 per day, or $3,650 per year (see figure 4). At this point, depending on the purchasing power parity levels prevailing in the local economy, a family can expect to have some discretionary spending and the ability to save.

This dramatic growth in consumption will bring its own strains on limited resources such as food, water and energy supplies, and intensify the strains on the biosphere. Richer societies can afford to address these challenges, just as China is addressing its problems of energy use. For these reasons, along with our confidence in the technological developments we expect in water management, food output and energy efficiency, we remain optimistic about the future. The world is becoming both fairer and richer, with more people from countries long excluded from the benefits of globalization at last starting to enjoy its fruits.

When we reach the next stage—Globalization 3.0—we will find that much has changed. The most notable feature of the new era will be how much older everyone will be. For the rest of this century, the fastest-growing demographic cohort, and thus the fastest-growing consumer group, will be people older than 60. In 1998, for the first time, the number of people older than 60 in the G7 countries was larger than the number under the age of 15. By the mid 2040s, that will be true of the whole world population. We are aging fast. By 2030, 36 percent of Germans and 30 percent of Chinese will be 60 or older. In 1950, some 200 million people worldwide

1 See related article, “The High Cost of the ‘Water Gap,’” on page 62 of this issue of Executive Agenda.
were older than 65; within 25 years that number will be 2 billion.

Industry Comes Home

The lesson of the Great Recession is that governments can cooperate in times of crisis, and that they have mostly learned the lessons of the 1930s: Sudden increases in protective tariffs and beggar-my-neighbor policies do not redistribute the cake. Rather, they reduce the size of the cake for everybody. Ominous new forms of protection have emerged, however, from “green” tariffs aimed at punishing those deemed to have irresponsible energy and carbon policies to currency manipulations that seek trade advantages through competitive devaluations.

Private industry is finding its own way to tackle the challenge of trade imbalances. GE, one of the remaining world-beating U.S. industrial giants, announced in October that it was launching a billion-dollar investment to bring manufacturing back to America. GE plans to invest this money during the next four years in appliances, starting with $430 million for four new U.S. plants to design and build refrigerators. GE currently sells $6.3 billion worth of appliances per year, but this new plan is important because it means that one of the world’s industrial bellwethers is in effect declaring an end to the 20-year habit of chasing “the China price” and outsourcing manufacturing to the cheapest supplier. GE has not gone mad. They recognize that the world has changed, and that the long-term effects of the China price on its home market include significant costs that have not yet been fully appreciated. The loss of American jobs and the consequent decline in American consumption is becoming a strategic problem for GE and for the U.S. economy as a whole.

“The next generation of products is going to be made in the USA,” said CEO Jeff Immelt, citing a number of factors in his decision. These include the high quality of U.S. manufacturing, the marketing desirability of a “Made in USA” label, rising labor costs in China, the mounting costs of transport, currency volatility, and the useful sweetener of $78 million in tax benefits.

It will take time to make the transition to a new, more sustainable and, with luck, more equitable Globalization 3.0. It may take three years or it may take 10, if the current volatility in currencies and commodity prices can’t be managed more predictably. The greatest test will be to avoid repeating the dreadful outcome of the Great Depression of the 1930s, which was ultimately ended by the coming of World War II. If that can be avoided, a new golden age may lie ahead.
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