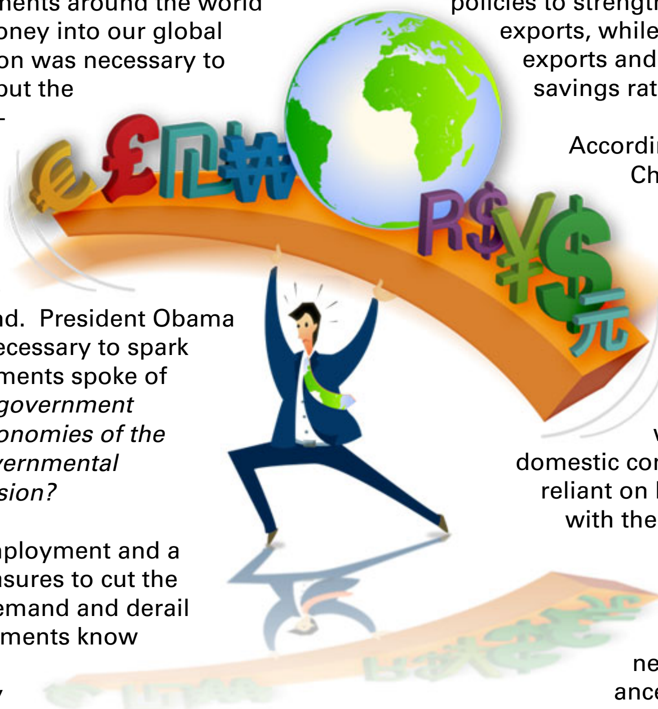
Global Imbalance

Up until now, the stock market's steep and steady upward ascent from the March 2009 lows was a welcome relief from the gut wrenching volatility and market meltdown caused by the 2008 subprime mortgage crisis. But this quarter's resurgence of volatility, coupled with the market's worst quarter since Lehman's fall and the market's worst May since 1940, dredges up our anxieties and fears formed by the Great Recession. This recent volatility may have been precipitated by Greece's sovereign debt crisis, but in actuality may be driven by the financial and economic imbalances plaguing our world.

The fragile green shoots of economic recovery were sowed by the coordinated effort of governments around the world injecting unprecedented sums of money into our global economy. Governmental intervention was necessary to save the world's financial systems, but the resulting huge budget deficits, especially for the wealthiest nations, have created an unstable imbalance that cannot be ignored.



These budget imbalances were the main topic of the Group of 20 (G-20) Summit held in Toronto last weekend. President Obama preached that more stimulus was necessary to spark growth, while the European governments spoke of austerity. *What happens when the government stimulus funds run out? Will the economies of the world be able to transition from governmental stimulus to a demand-driven expansion?*

The dilemma is that with high unemployment and a tapped out consumer, austerity measures to cut the government deficits may squelch demand and derail the recovery. The European governments know that the credibility of their financial markets and their credit ratings may be at stake unless the deficits are confronted. Europe's sovereign debt crisis after driving down the euro has now spilled over to concerns about their banking system.

These same problems are reflected here at home. Our $1.4 trillion federal deficit is the largest in the world and our largest since World War II. The enormous stimulus we injected into our system over the past year has been ineffective in lowering our jobless rate much below 10%. The US consumer has pulled in his purse strings and actually is saving a little. The already strapped states will see the stimulus spending come to an end while Congress is struggling to pass any spending measures that would widen the federal deficit.

The consumer is the largest portion of the US Gross Domestic Product and has always led the world out of recession. Faced with higher taxes to cut the federal deficit and high unemployment, the US consumer will be hard pressed to provide the stimulus. This time must be different. Because we are the largest economy in the world, denominated by the almighty dollar, our government might be able to add some stimulus. But more debt-financed overspending will exacerbate the imbalances and could lead to the same problems Europe is now facing.

Besides budget imbalances, the subplot of the G-20 Summit was the trade imbalances that are dampening the global recovery. Countries, like China, Germany and Japan, are relying on exports to bolster their economies. While countries like the US, India, and the UK are buying their exports and running trade deficits. The G-20 wants these countries to rebalance themselves. China was cajoled to establish policies to strengthen internal demand to reduce exports, while the US needs to increase exports and reduce imports by increasing its savings rate.

According to *The New York Times*, many Chinese coastal factories are raising salaries by 20%-30% to about $300 per month with local governments also raising minimum wage standards. For example, Beijing's minimum monthly wage was recently increased by 20% to about $140. It is hoped that wage increases will stimulate domestic consumption and make China less reliant on low-priced exports. This, coupled with the recent action by the Chinese central bank announcing that it would allow the yuan, the Chinese currency, to appreciate against the dollar, are the steps necessary to address these imbalances.

The US, along with the other advanced economies of the G-20, agreed to cut their deficits in half by 2013. The US is relying on faster economic growth to reach its goal, while Europe and the UK will propose more severe austerity measures. To compromise, the G-20 statement labels the pace of deficit reduction "growth friendly".

It's going to be a tough balancing act, but the cooperative efforts of the G-20 countries provide the blueprint for long-term sustainable growth. As investors, we must keep a long-term perspective in order to manage the uncertainties during times of transition.

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4940 Washington Blvd.
St. Louis, MO 63108

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