Economic Growth Program and World Economic Roundtable Policy Paper

Building a Bridge to a Tri-Polar World Economy: An American Growth Strategy

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May 2013

Five years into the global financial crisis, the prospects for economic growth are again deteriorating. The IMF has revised downward its 2013 forecast for world economic growth to 3.3 percent, confirming that a worldwide economic growth compression is still at work.[1] U.S. GDP growth in the first quarter of 2013 came in at 2.5 percent, well below estimates, and is expected to weaken further as cuts in government spending and payroll tax hikes together with headwinds from Europe and China continue to act as a drag on the U.S. economy.[2] The Euro-zone remains in recession, as economic weakness has spread from the southern Euro-zone economies to Germany and other core economies. Meanwhile, Euro-zone unemployment has risen to a record 12.1 percent, with jobless rates in Spain and Greece at depression levels of more than 25 percent.[3] China's growth rate has compressed from its double-digit average of the past several decades to less than 8 percent.[4] And Asia and emerging markets more broadly face slower growth in the coming years as they attempt to move from investment-led to domestic consumption-led growth.

More worrying, there are signs that the foundations of the world economy – at least as we have known it over the past 20 years – are eroding. Economic growth models lie broken across developed and emerging markets alike. Globalization is in retreat as financial institutions retrench and re-nationalize. Debt levels in most of the advanced economies are approaching politically, if not economically, unsustainable levels, forcing policy makers to rely almost exclusively on Central Bank monetary measures that carry excess liquidity risks and have diminishing returns. As growth compresses and unemployment rises, the political temptation to enact policies that protect rather than expand has increased. Early signs of a creeping beggar-thy-neighbor tendency are evident in world currency markets, as one economy after another has sought to weaken its currency to gain competitive advantage and increase net exports. If allowed to continue, the resort to beggar-thy-neighbor measures could bring an end to the world's second great try at globalization.

Of all the major developed economies, the U.S. economy is in the best position to break out of this five-year growth compression and to fix its broken economic growth model. Over the past few years, it has developed several new potential drivers of economic growth powered by Middle America – a shale oil and gas revolution that could make the United States a surplus energy producer, a manufacturing renaissance made possible by lower energy and labor costs and the adoption of advanced manufacturing techniques, and new technological advancements in cloud computing and biotechnology. Together, these developments could make the U.S. economy less dependent on debt-financed consumption and increase its growth potential.

But this transition to a more investment- and production-led economic model with strong economic growth is being held back by the unfavorable world economic conditions in Europe and Asia and by a premature move toward fiscal consolidation at home. The latter has been prompted in part by a worry that global capital markets will at some point turn against U.S treasuries.

For U.S. policymakers concerned with international economic policy, these developments pose a dual challenge: how to mix international concerns with domestic policy to put the U.S. economy on a new robust economic growth path of 3 to 4 percent a year; and how to stabilize globalization and point it in a more sustainable direction. Five to eight years out, there is the promise that a rising global middle class in emerging economies will help drive demand for U.S. goods and services and will usher in an era of more balanced world economic growth. The challenge is how to get from here to there, given the concurrent crises in the United States, Europe, and Asia.

In the late 1990s, following the Asian financial crisis, the United States was able to stabilize the world economic system by absorbing the surpluses of troubled Asian (and Brazilian) exporters. But today the world economy is much larger, the crisis much more widespread, and the U.S. economy much less able to act as the world's consumer of last resort. Given the global nature of the growth compression, the ideal solution would be a coordinated world economic recovery with each major region committing itself to fiscal as well as monetary expansion and with the international lending agencies channeling resources into the most depressed debtor economies.

But Germany and other major economies have ruled out such an ambitious approach, opting instead for a program of fiscal retrenchment and structural reform in spite of growing evidence that this approach is not working and that an alternative is needed. The United States has more recently followed course with its own form of fiscal austerity created by a series of small fiscal deals that have raised taxes and cut government spending.

Faced with fiscal contraction at home, the Obama administration seems to be moving to a strategy of trying to offset the fiscal drag with external demand by talking up future free trade agreements with Europe and Asia.[5] But such a strategy runs up against the realities of weak global demand and Asia and Europe's own goal of exporting their way out of the current economic slowdown.

This paper explores the options for supporting a transition to investment- and production-led growth at home while averting beggar-thy-neighbor policies globally – creating a bridge to a more balanced global economy. It explains why the current mix of international policy is not working and why it is complicating the transition to a more balanced U.S. economic growth model. It then shows why the administration's proposed strategy of pursuing new free trade initiatives with Europe in the Atlantic and with Japan and the Southeast Asian economies in the Pacific will fall short of the dual goal of facilitating the transition to a new U.S. growth path and preventing the further collapse of globalization. Finally, it lays out a road map for an alternative growth strategy that would combine a bold public and human capital investment program at home with an international strategy that would deepen integration with our trading partners in the Americas and in so doing provide a model for other major economies to proceed with their own regional economic deepening. This would set the stage for globalization's next iteration: a more balanced tri-polar world economy.

The Post-Financial Crisis Problem: Broken Economic Models and Unbalanced Policy

By now, it is widely understood why recoveries from financial and banking crises tend to be more difficult and much weaker from normal business cycle recessions. But this recovery has been particularly difficult for several additional reasons.

To begin with, the crisis was the product of major flaws in the economic growth models of each of the major geo-economic regions: the United States, Asia, and the Euro-zone. As such, each of these regions now has a broken economic model that requires structural changes to fix. The obvious flaw in the U.S model was its over-reliance on debt-financed private consumption that was made possible by consecutive asset bubbles – first the tech bubble and then the housing and credit bubble. These bubbles were fueled in part by large capital inflows from Asia and other surplus economies, which the U.S. financial system leveraged many times over to finance a housing and consumption boom.

America's excesses in turn were integrally connected to Asia's unbalanced investment and export-oriented model. Asian economies, beginning with Japan but to an even more excessive degree China, produced more than they consumed and thus were dependent on exports to consumer markets in the United States and Europe.

Europe suffered from its own imbalances as a result of the introduction of the euro currency in 1999. The euro led to what can best be described as a vendor financing scheme between the more production-oriented economies of northern Europe, particularly Germany, which provided the goods and financing to the more consumer-oriented economies of southern Europe. For a while, the southern economies enjoyed exceedingly low interest rates. But this led to real estate bubbles and forms of over-consumption fueled by rising debt. In the process, Germany, which was already an export power-house, became even more export-oriented rather than the consumer that the rest of Europe needed.

The fact that the economic models of all three major geo-economic regions are broken concurrently has profound implications for world economic growth and U.S. international economic policy.

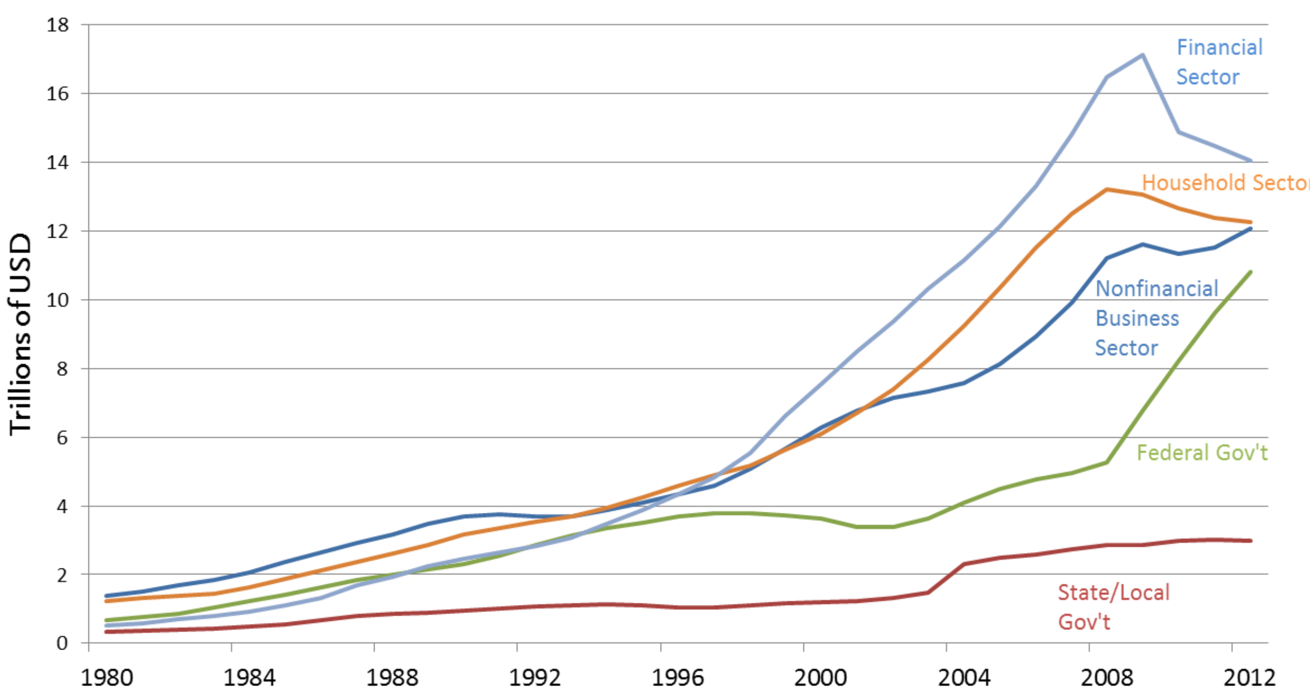
First, it means that the crisis not only knocked out the major drivers of economic growth in the world economy over the past decade but it also rendered them relatively unresponsive to quick stimulus fixes. U.S. consumption, for example, remains constrained by high household debt levels, high unemployment, and weak income growth, which cannot be fixed by temporary tax cuts or short-term stimulus spending.[6] China's growth is similarly restrained, but in its case by overcapacity and weak export markets and the need to shift from export demand to domestic demand-led growth. And the euro-zone is constrained by the politics of austerity and the straightjacket of a single currency, which prevents the deficit economies from devaluing their currency as part of an effort to regain their competitiveness.

Second, the concurrent nature of the economic crisis explains why it has not been possible for a new global locomotive to emerge. It may have been possible for the United States to pull the world economic order along after the Asian financial crisis in the late 1990s and for the U.S. and Chinese economies to act as dual growth engines in the early 2000s after the bursting of the tech bubble, but today no economy is in a position to pull the rest. As a consequence, world economic recovery requires either a coordinated expansion as envisioned by the 2009 G-20 Summit in London[7] or a carefully sequenced structural adjustment process.

Third, in a deeply depressed global economy with inadequate demand, it is essential for the surplus economies to take the lead with macroeconomic policy and structural changes. They need to expand demand in order to make room for the deficit economies to improve their trade accounts and work their way out of currently unsustainable debt levels. But, aside from some initial stimulus, China and Germany have resisted pressures to expand consumer demand or, in the case of China, have faced political and structural constraints in doing so. Most of the burden, especially in the Euro-zone, has therefore fallen upon the deficit economies to adjust. This asymmetrical adjustment process, not surprisingly, has led to near depression-like economic conditions in the periphery of Europe and weak economic growth in the core. In the case of the United States, the failure of adjustment in Europe and Asia has constrained its effort to improve its net export position and slowed its transition to a more investment- and production-led growth model (more about this later).

Another major factor inhibiting the world economic recovery has been the large debt overhang left by the crisis in virtually all the major developed economies and the corresponding effect that has had on the choice of economic policy. At the height of the crisis, total U.S. debt involving all sectors of the economy reached a peak of 373 percent of GDP.[8] While private sector deleveraging has made some strides, public sector debt has increased significantly, resulting in only a modest overall deleveraging with debt coming down to 340 percent of GDP (**see Figure 1**). In Europe, the deleveraging process has barely begun

Figure 1: US Debt by Sector, 1980 - 2012



Source: Federal Reserve

as public sector debt levels continue to rise, while Japan's gross government debt has reached 230 percent of GDP.[9] China faces its own debt problems with the growth of shadow lending and the buildup of local bank leverage that has fueled local real estate bubbles.

The large debt overhang affecting all these economies has inhibited economic growth in two ways. It has done so directly by limiting demand, as deleveraging causes households to pare back spending in order to repair balance sheets and financial institutions to restrict credit in order to meet tougher post-crisis capital requirements. It also has done so indirectly by influencing the choice of macroeconomic policy. With high public sector debt levels, political leaders have been reluctant to sustain expansionary fiscal policy for any period of time, leaving monetary policy the only tool of choice. The reluctance to use expansionary fiscal policy has been reinforced by the dominance of orthodox economic thinking in much of the developed world, but especially Europe.

As a result, effective fiscal policy has been visibly absent, with the notable exception of China's aggressive 2008-09 fiscal stimulus program. While China's policy bolstered Chinese economic growth and indirectly world economic growth for a brief period, even China has been forced to tread carefully with further stimulus because of growing domestic credit concerns and rising internal inflation.[10] Meanwhile, Europe has adopted what amounts to a pro-cyclical fiscal austerity policy: government spending cuts and tax increases in the hard-hit periphery and a drive for a balanced budget in Germany. Over the past year, the United States has followed suit with its own fiscal consolidation with a series of tax increases and spending cuts, leaving only Japan to buck the global trend.

Thus, nearly the entire policy burden to counter the global growth compression has now fallen on monetary policy, or to be more precise with interest rates already near the zero-bound, on extraordinary Central Bank action. The Fed has led the way with repeated rounds of quantitative easing involving the purchases of Treasuries and mortgage-backed securities, followed by the Bank of England, and to a lesser extent the European Central Bank, which with its Outright Monetary Transactions program has pledged to buy government bonds in the secondary market. More recently, Japan has joined the league of extraordinary monetary policy with the announcement of monetary measures by new Bank of Japan Governor Haruhiko Kuroda, which may outdo the Fed's expansion of its balance sheet.[11] (Japan is the only major economy to employ the twin engines of aggressive monetary and fiscal policy to jumpstart economic growth, a policy choice that has been rewarded with a massive stock market rally. See: *From Growth Compression to Reflation — The Road Ahead*.)

The resort to ever more exotic forms of Central Bank actions suggests that monetary policy may be approaching the end of the road. Indeed, as John Makin of the American Enterprise Institute has noted, "Central Banks are being asked to promise more than they can deliver."[12] Monetary policy is useful in helping to provide liquidity and to stabilize financial systems, but it has a limited effect on creating real demand. This is especially true when the financial transmission mechanism from the Central Bank to the real economy is broken either because banks have too little capital to lend or because there is too little demand for credit because of general weak economic activity. (This is true across nations as well as within as finance-sector globalization has come to an end as a result of the crisis).

Not surprisingly, extraordinary monetary policy has with each new round of quantitative easing produced diminishing returns in terms of growth even as the side-effects of the monetary medicine have increased. In the United States, for example, there is a visible disconnect between weak economic activity and a rising stock market, which raises the question whether monetary policymakers are proving too ineffective in terms of impacting the real economy but too effective in influencing asset prices. The political optics around new all-time highs for the S&P and 7.5 percent unemployment are deeply worrisome, as are the consequences for the world economy.

The potential dangers associated with long periods of ultra-low interest rates extend further. They give rise to the misallocation of capital, the reach for yield, and new asset bubbles as investors move into ever more risky assets to compensate for the ultra-low yields in government bonds and other safe assets. The proverbial "wall of global liquidity" rushes into real estate and equity markets. In the context of weak global economic growth, excessive monetary policy can also set in motion a beggar-thy-neighbor competitive devaluation process. A sharp depreciation in the currency of one major economy as a result of Central Bank action can easily lead other countries to take measures to counter the competitive effects on their own economies.

The United States may have inadvertently begun the depreciation process with the Fed's September QE3 announced commitment to sustain monetary easing until unemployment reaches 6.5 percent, but it may not be the ultimate beneficiary. Japan has since followed with its new monetary measures, sending the yen falling. That was quickly followed by a South Korean warning that the won was too strong and that Japan's monetary easing was to blame. It also provoked comments from German and other European officials about the effects of a falling yen on the Euro-zone's already dismal economic picture. In this context, it is useful to remember how the Chinese devaluation in 1996 set in motion a series of hot money capital flows and then devaluations – first Thailand, then South Korea and later Brazil – that led to the Asian 1997-98 financial crisis.

In sum, the combination of broken economic models, asymmetrical adjustment within and among geo-economic regions, and over-reliance on monetary policy has produced the worst of both worlds: stagnant economic growth, on the one hand, and asset bubbles and competitive devaluations, on the other. It has also brought us to a fork in the road. Down one path lies the prospect of trade and currency wars and down the other is a yet-to-be-defined pro-growth adjustment path.

The U.S. Transition to a More Investment and Production Oriented Growth Model: The Rebirth of Middle America

In spite of this unfavorable world economic environment, the United States has made some progress toward generating an economic recovery and fixing its economic growth model. It has the strongest of the developed world economies and has benefited from what I have coined the "Rebirth of Middle America." By Middle America I mean those parts of America's productive economy that are centered in the middle of the country, namely the old industrial and agricultural heartland.

Middle America's rebirth is based on three main factors:

- An energy revolution in shale oil and gas that has led to a surge in U.S. energy production, which has helped reduce the U.S. trade deficit and added to U.S. economic growth. The boom in shale gas has also improved the competitiveness of U.S. manufacturing, especially those manufacturers that use natural gas as a feedstock or energy source.[13]

- A manufacturing revival that has been made possible by lower energy cost and a decline in productivity-adjusted labor costs relative to those of our main competitors.[14] U.S.-based manufacturing has also benefited from the early adoption of advanced manufacturing techniques and processes and from a nascent shift to onshoring for political as well as economic reasons.

- An ongoing agricultural boom that has resulted from growing emerging market consumer demand for more protein and from advances in American life and biotech sciences. The latter has enabled American agriculture to be less affected by extreme weather developments that have come to pressure global supply.

Middle America's rebirth is significant because it offers the outlines of a stronger and healthier American growth model that is less reliant on debt-financed consumption and driven more by production. But the transition to a more balanced economic growth model is far from complete. The U.S. economy is still too dependent on consumption, still runs a sizeable trade deficit, and still suffers from a number of problems that are holding back its recovery.[15] Among those problems are:

- Low levels of both public and private capital investment, which threaten to reduce the economy's long-term growth potential.

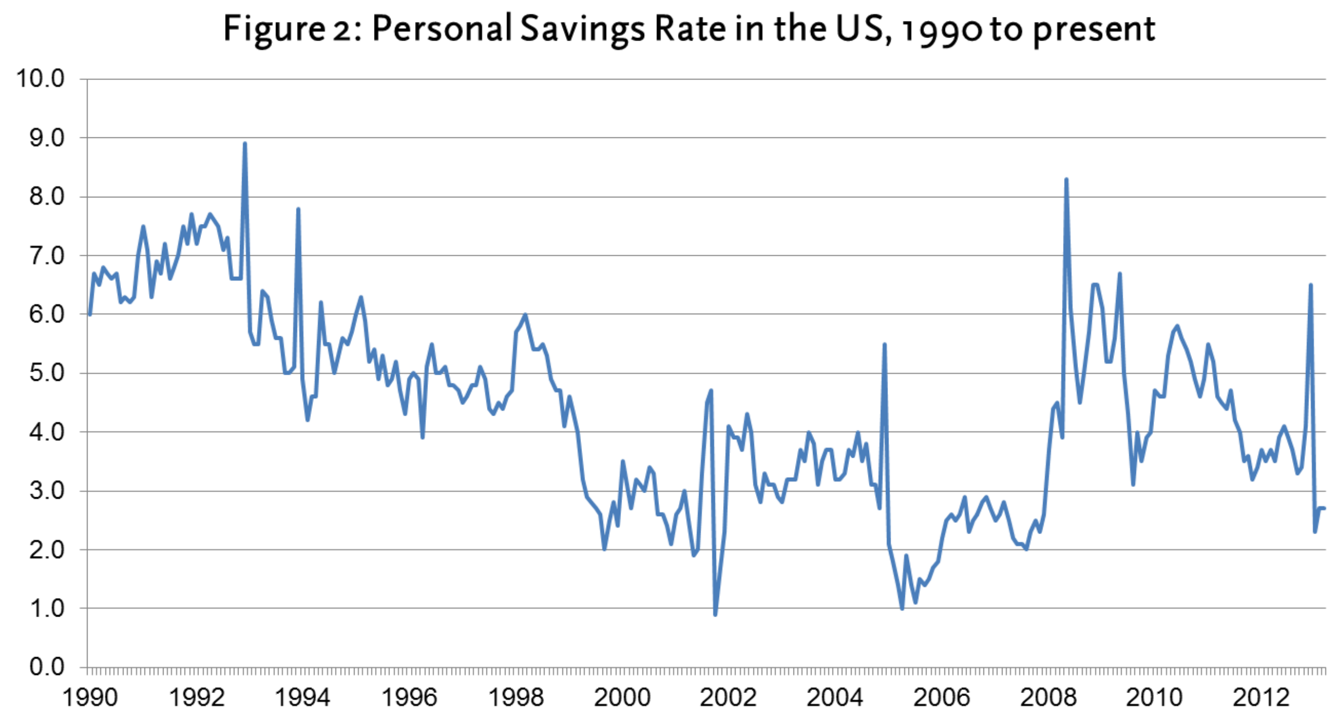
- High levels of unemployment and underemployment, with a substantial increase in the number of people who are long-term unemployed.

- Weak income growth and the further hollowing out of middle-class jobs, which makes consumption dependent on an ever thinner slice of the American public or on the continued rundown of the personal savings rate.

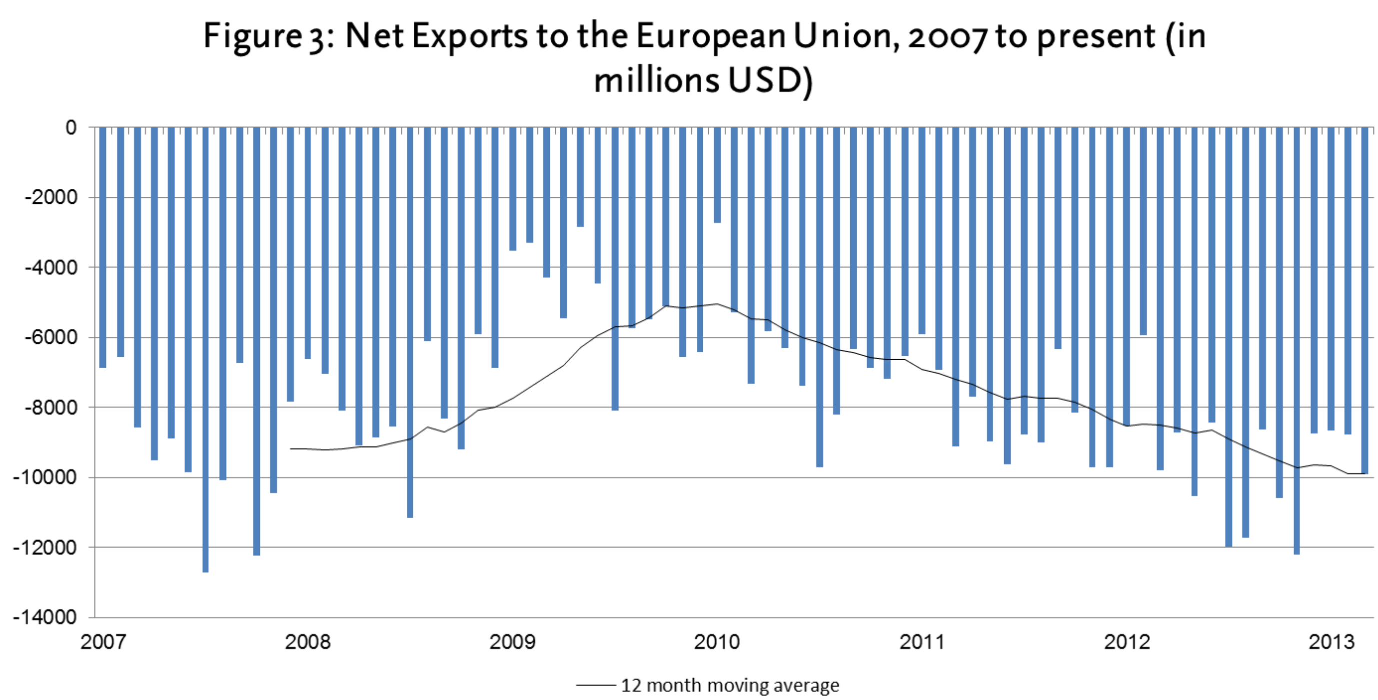
If we are not able to correct these problems, they will reduce the economy's economic growth potential and increase the risk of either stagflation or Japan-style stagnation in the future. Even as it is, the shift over the past year to the current mix of easy monetary policy and tighter fiscal policy together with weak global demand threaten to undo some of the progress made toward a more balanced investment- and production-oriented economy. Three points bear mentioning in this connection.

First, the mix of easy money and tighter fiscal policy tends to reinforce features of the old consumption-oriented growth model while negating some of the main features of the Middle American growth economy. Low interest rates may have helped bring about a modest housing recovery and lifted U.S. stock prices, but they have done little to spur new investment to create new jobs. After rising at a reasonable healthy pace in 2010 and 2011, growth of nonresidential real capital expenditures in the private sector has declined and even became negative in the third quarter of 2012.[16] Meanwhile, we are back relying on a drawdown in savings and the Fed's monetary policy to produce a wealth effect from rising asset prices to help maintain current consumption levels (**see Figure 2**).

Second, the U.S. manufacturing rebound has stalled out. Manufacturing is particularly sensitive to external demand and to exchange rates. U.S. manufacturing production enjoyed a recovery in 2009-11 but rose much more slowly in 2012. So notwithstanding an improvement in U.S. competitiveness owing to lower energy and relative labor costs, manufacturing has yet to recover to its 2007 peak.[17]



Third, net export growth is no longer the positive contributor to U.S. economic growth it was early on in the recovery. Today, the external engine of U.S. economic growth is sputtering as the global growth compression reduces external demand. U.S. real export growth has slowed from 11 percent in 2010 to 7 percent in 2011 to less than 4 percent in 2012.[18] One reason for this decline has been the deteriorating economic growth picture in Europe. Net exports to the European Union have declined by 37 percent from 2010 to 2013. In the latest month, US exports fell by $1.7 billion – led by a 9-percent year-over-year decline in exports to the European Union (see **Figure 3**).[19]



Pinned in by political gridlock with Congress and by deteriorating global economic growth, the Administration has been forced to rely on the Federal Reserve to provide ever larger doses of monetary stimulus to the economy. This has resulted in the reversion to major features of the old economic growth model.

Misreading the World Economy: The Limitations of Current U.S. Economic Policy

The current political deadlock in Washington has led to another shift in American policy. In recent months, the administration seems to have given up on the fight over fiscal policy. Instead, it has set off on a strategy to compensate for the loss of demand with an international effort to expand trade with Europe and Asia, as evidenced by its push for both a Transatlantic Trade and Investment Partnership (TTIP) and Transpacific Partnership (TPP). If there is a logic to the administration's approach, it seems to be a calculation that the United States can reduce its deficit and still grow by increasing its net export position and by relying on external demand.

In opting for this export-led strategy, the administration is making two further calculations. First, it is betting that Europe and Asia will soon make a turn toward growth and that rising demand in those regions will help drive economic growth over the next several years. It is also calculating that opening up negotiations on free trade agreements will help reinforce or advance the pivot to growth on the part of Europe and Asia. Unfortunately, the administration is likely to be wrong on both scores.

Let's take a closer look at the growth prospects in Europe and Asia. Given current trends, Europe faces a lost decade of economic growth – similar to or worse than the lost decades Japan has suffered from since the bursting of its bubble in the early 1990s. As noted earlier, Europe's deleveraging process has barely begun. Its outsized banking system is roughly four times the size of its economy (by contrast, U.S. banks are smaller than the total U.S. economy), and is filled with yet-to-be recognized bad loans.[20] European bank deleveraging could easily turn deflationary much like Japan's did in the early 1990s. Unlike Japan, however, Europe has not been willing to counter the deflationary effects of decreased bank lending with a more expansionary fiscal policy and is unable to act in a concerted fashion given the unwieldy nature of Euro-zone governance. To be sure, there has been some acknowledgement in recent weeks that pro-cyclical austerity policies are driving the Euro-zone into a depression and some talk of easing up on austerity. But there is little evidence that European leaders have an alternative growth strategy in mind other than the European Commission giving hard-pressed deficit economies more time to meet the Commission's deficit reduction targets.

Easing up on austerity and budget targets in Greece, Portugal, Spain and other peripheral economies is of course welcome. But for the larger European growth picture, it is a bit of sideshow. The real concerns are in the core – France, the Netherlands, and Germany itself – where growth has also compressed and recession threatens to take hold yet where fiscal policy remains far too restrictive. Concerns are also with the larger structural constraints of the Euro-zone, which prevent weaker economies from using the full range of tools – currency as well as monetary and fiscal policy – to support an economic recovery.

There are essentially two options for Europe to make a major pivot to economic growth. One would be a significant change in German policy. As noted earlier, the imbalance within Europe – between Germany (and a few other core surplus economies) and the rest of the region – is at the heart of Europe's structural woes. The periphery economies cannot successfully adjust and begin to grow robustly again unless Germany takes corresponding measures to increase consumption by pursuing a more expansionary fiscal policy. Yet there does not seem to be the political consensus or even the political understanding within Germany to support this more pro-growth agenda, especially because it would also require Germany to accept somewhat higher inflation in the future. The German decision to stick with its plan to bring its structural deficit to zero by 2014 – the so-called debt brake – is reflective of just how seriously Germany is committed to its "fiscally responsible" position.

As German economic officials have made clear, they are committed to an adjustment process that will make the southern Euro-zone economies more like Germany by increasing their competitiveness and the competitiveness of the Euro-zone as a whole. Thus, Germany's strategy seems to be to compensate for the lack of internal demand by increasing Europe's surplus with the rest of the world, a strategy that directly conflicts with the U.S.'s own goal of export-led growth.

The other option would be for the reorganization of the Euro-zone into a multi-tier euro – with a hard (more expensive) core of northern European states, a middle core of economies like Italy and Spain, and soft (less expensive) group of weaker southern economies like Greece and Portugal. A multi-tier Euro would facilitate a healthier internal adjustment within Europe by making German exports more expensive. This would encourage Germany to increase its internal demand while allowing southern economies to regain their competitiveness more quickly, thereby accelerating the adjustment process. The problem with this option is that reorganizing the Euro-zone would be a complex and timely process and would not yield quick results that would improve the growth outlook in the short term.

The Obama administration is correct to try to forestall any further descent into beggar-thy-neighbor policies with its emphasis on trade expansion, but it is wrong to believe that a commitment to conclude a trade and investment partnership with Europe would improve the prospects for U.S. export-oriented growth. The idea of TTIP ignores Europe's dismal economic growth outlook, making it difficult to see what the benefits of such a free trade agreement for the United States would be. It also ignores Germany's strategy to increase the Euro-zone trade balance with the rest of the world, leaving open the possibility that the Euro-zone will attempt to improve its economic position at our expense. In this sense, the timing of the administration's initiative is also questionable. Rather than pushing Europe toward more pro-growth policies, it may only divert Europe's attention from the more expansionary policies it must pursue and the internal adjustments it must make, beginning with Germany, in order to increase economic growth. The United States needs to send the message that Europe must to do more to create its own regional demand, not hold out hope that Europe can free-ride off American demand in order to sustain its pro-cyclical austerity policies into the future.

The economic growth outlook in Asia is, of course, brighter than in Europe. But China, the largest economy in Asia, has its own cloud hanging over it, as does Japan. In general, the outlook in Asia is dependent upon China successfully making a long and difficult transition from a heavily investment- and export-led economy to one that relies more on domestic demand and consumer-oriented growth. Indeed, as European and American consumer markets shrink relative to the size of the world economy, China must increasingly become a larger consumer for itself and the rest of Asia. The Chinese leadership understands that it needs to make this transition given the weakening of its main consumer export markets in Europe and the United States and given China's changing demographics toward an aging urban population. But the challenges are still enormous, and the outlook for success is at best uncertain.

China's recent growth successes have left it badly unbalanced: investment accounts for between 45 and 50 percent of GDP, one of the highest levels ever, while consumption, normally around 60 percent for large emerging market economies, hovers around 35 percent, again one of the lowest in modern world economic history.[21] Overcapacity and declining if not negative rates of return on investment afflict most sectors of China's industrial economy. Household debt levels have risen sharply, from 31 percent in 2008 to 54 percent in 2011, as the real estate boom (and bust) works its black magic.[22] As a result of overinvestment in both manufacturing and infrastructure/real estate, the formal banking system is exposed to rising bad debts. And a shadow banking system with potentially even more exposure to bad debts has sprung up in recent years without government supervision.

Bringing these problems under control will increase the stress in China's governing system. Despite the image of an all-powerful coordinated guidance system, the central government in Beijing and the local governments in different regions of China often work at cross purposes. In the current situation, the many incentives local and regional governments have to continue to build with cheap credit are misaligned with the central government's goal of containing reckless lending and curbing overinvestment.

However China works through these problems, the outlook is for much slower economic growth over the next five years. New Premier Xi Jinping's target of 7.5 percent growth pales in comparison to the double digit growth of the past decade, but yet may still be harder to meet. Experienced China observers, like Michael Pettis, predict even slower growth and a more difficult transition than the leadership expect. As Pettis notes, in order to stimulate consumption relative to investment, China will need to take three structurally difficult and politically contentious steps: end the financial repression that transfers money from households to producers; increase wages in order to expand the purchasing power of ordinary Chinese; and further liberalize its financial system and revalue even more the currency to make imports cheaper.[23] It would also help if China would put in place a stronger social safety net so that the surplus savings of the corporate sector do not end up as increased precautionary savings in the household sector.

All these steps, of course, run up against the interest of China's state-owned enterprises that have been the big winners of China's growth miracle. Hence it would be reasonable to expect more political infighting – and more capital flight as wealthy Chinese seek to hedge their bets by building wealth outside of China (to the benefit of high-end real estate in New York and London). It would also be reasonable to expect that if the transition to a more consumer oriented economy falters, the Chinese leadership may fall back on China's old economic model of cranking up investment and pushing goods out into the world market at the expense of the U.S-China trade balance.

Given the huge trade imbalance with China, the United States has an enormous stake in a successful Chinese transition to a more balanced economic growth model. The administration has yet to figure out what, if anything, it can do to make a successful transition more likely. As now configured, the administration's TPP initiative seems more intended to isolate China than to make it the central consumer in Asia's regional economy. By expanding investment and trade with Southeast Asia, the TPP would have the effect of widening the low-wage production zone for American companies into less-developed Southeast Asian economies. That, of course, is already happening as companies in China move production to Vietnam, Cambodia, Laos, and Bangladesh.[24] But it is not clear how the goal of creating greater global demand for U.S. exports would be served by trading one low-wage production zone for an even lower one. If anything, that would only increase the global imbalance between supply and demand in the near term. The key strategic objective for U.S. trade policy in Asia should be to facilitate the emergence of its middle class – not delay its development.

Figure 4: Current Account Balances, China, Germany, and United States, 1999-2012

Source: IMF World Economic Outlook

In that sense, there may be promising trade prospects in other parts of the world economy, many of them which reside in the Americas. Robust macroeconomic frameworks, strong domestic pension funds, rising consumer demand growth, powerful commodity export profiles and more can be found in Mexico and further south into Latin America. In the Middle East, the Gulf countries, after several years of record oil production and prices, are also rising in economic importance as oil wealth is translated into domestic demand and hence potential export opportunities.

Toward a New American Growth Strategy

In short, current U.S. international economic strategy is based on a serious misreading of the world economy. A better understanding of the most important trends over the next five years would lead to three broad strategic conclusions for American policy.

First, as Europe and Asia work their way through difficult transitions to new growth models, global demand will remain weak. Given the large debt overhangs all the major developed economies suffer from and given the obstacles to China's transition to a more consumer-oriented economy, there will be a temptation on the part of each of these economies to try to export their way to economic growth.

But all three major geo-economic regions cannot improve their net export positions simultaneously. The rest of the world is simply too small and there is simply too little demand. This means that it will be difficult for the United States to substitute external demand for internal demand at least in the near to medium term. It follows that the United States will need to do more to generate its own demand, but in a way that increases investment and production relative to consumption so as not to fall back on its old model of debt-financed, consumer-led growth.

Second, global capital will remain plentiful – indeed, potentially too plentiful. The current push for U.S. fiscal austerity and debt reduction is based in part on the fear that as global economic growth picks up interest rates will rise and U.S. access to capital may become more difficult. But this idea is contradicted by trends in Europe, Asia, and the petro-dollar economies of the Persian Gulf. Rather, trends point to what a Bain & Co. report calls the continuation of the era of "super-abundant capital."[25]

One reason for a continued glut of global savings, according to a study by Goldman Sachs, is that people in the largest emerging markets are just now approaching their peak savings period – and are doing so without the kind of social safety nets that have made saving less necessary in advanced Western economies.[26] This means that at least through 2020 global savings and consumption trends will continue to put downward pressure on interest rates, and that the United States will be able to continue to borrow at a relatively low cost. It also means that as a result of China's transition to a more consumer-oriented economy, the United States could become a destination for increased foreign direct investment from China much as it did from Japan in the late 1980s and early 1990s. After years of absorbing a disproportionate share of world FDI, China's inability to invest that capital well will most likely spur greater outbound FDI. This would represent a potential boon to America, not a threat.

Third, the most promising markets for American goods and services may not be in Europe or Asia in the near term. Yes, the projected expansion of Asia's middle class over the next decade or two offers a market the United States cannot ignore. Some analysts estimate the middle class in China and India will grow to close to a billion people by 2020.[27] But their savings may grow even faster than their consumption given the Asian propensity for export-oriented economic growth. Thus tighter integration with Asia may not result in an improvement in America's net export position.

In the next five years, the most promising areas of economic growth that are compatible with the U.S. goal of creating a more balanced economy can be found in America's own hemisphere. The heavy emphasis on expanding trade and investment in Europe and Asia therefore may be misplaced especially if it leads the United States to ignore more promising possibilities in the Americas.

These three conclusions in turn lead to a fourth much larger conclusion about America's international economic growth strategy. The opportunity for the United States lies not in expanding its exports to Europe and Asia but in leveraging its access to the globe's financial and human capital in order to rebuild its infrastructure, maximize the promise of Middle America's Rebirth, and take full advantage of the economic growth opportunities in Latin America. By seizing this opportunity, the United States can lay the foundation for a more robust and more balanced domestic economy, contribute to global demand and reduce beggar-thy-neighbor risk, and provide a model and incentive for Europe and Asia to pursue regional demand-deepening adjustment strategies themselves.

An Inside-Outside Growth Strategy: Fostering Investment in America's Physical and Human Capital

Given the weak external demand picture laid out above, the question becomes how the United States generates more of its own demand without returning to the debt-fueled consumption of the pre-crisis years. The answer lies in a pro-growth investment policy that leverages global financial and human capital to meet America's physical and human capital needs.

Two points are worth emphasizing at the outset:

First, with abundant and low-cost global capital freely available, the United States can pursue both a robust fiscal policy and an expansionary monetary policy. Indeed, under the current economic circumstances, the two work better together with fewer side effects than relying primarily on extraordinary monetary measures.

Second, by emphasizing public capital and human capital investment, the United States will be able to support global demand and growth but in a way that minimizes the ability of other countries to free ride on American consumers to the extent they did a decade ago. The United States can thus expand internal demand in a way that helps the economy become more investment- and production-oriented without "taking" demand from other economies.

With those two points in mind, let's begin with America's physical capital needs, which run the gamut from ports to roads, to rail to water systems, to electric grid, broadband and beyond. As documented by the American Society of Civil Engineers and other groups, these needs are well known and amount to well over $1 trillion over a five-year period in needed new investment beyond what is currently expected.[28] What is important here is not to repeat the usual litany of those needs but to explain the strategic economic logic for a large infrastructure investment program as the principal component of a five-to-eight year economic growth strategy.

Infrastructure investment supports economic growth and job creation in a cost effective way because it has a healthy multiplier effect. Every dollar of investment in infrastructure is estimated to generate an increase of $1.59 in GDP, or possibly more.[29] And every billion dollar of infrastructure investment creates as many as 23,000 jobs directly and indirectly – the great majority of which would be good jobs paying middle-class wages.[30] Infrastructure investment has a healthy multiplier effect in part because the demand it creates does not leak out to the same degree that stimulating consumer spending does.

At the same time, infrastructure investment would make the economy more competitive and productive. The World Economic Forum ranks the United States 25th in the quality of its infrastructure, far below that of our main competitors.[31] Infrastructure investment can increase the competitiveness of American-based business by eliminating infrastructure bottlenecks and by lowering the cost of transportation, communication, electricity, and other core business expenses. It thereby allows the United States to gain market share in tradable goods and services without resorting to protectionist measures.

Major new infrastructure investments are needed to realize the full potential of the Rebirth of Middle America. Because of several decades of under-investment, infrastructure bottlenecks are holding back the development of energy resources and the expansion of our manufacturing sector.[32] If properly designed to support the realization of the rebirth of Middle America, a major infrastructure investment program would advance integration with our trading partners in the Americas. As Joel Kotkin has pointed out, America's existing infrastructure is routed east to west. But the new growth corridors that are developing as a result of the rebirth of the Middle American economy tend to require infrastructure that moves from north to south.

A large public-supported infrastructure investment program also would be able to leverage both domestic and global private capital to support U.S investment and economic growth. It would do so because it would create the kind of attractive low-risk, long-term investments that long-term oriented institutional investors like pension funds, life insurance companies, and sovereign wealth funds desperately need in this ultra low-yield world. Indeed, the match between billions if not trillions of dollars in private capital in search of yield and America's infrastructure investment needs could become one of the great investment and growth stories of this decade – if we put in place the necessary public framework.[33]

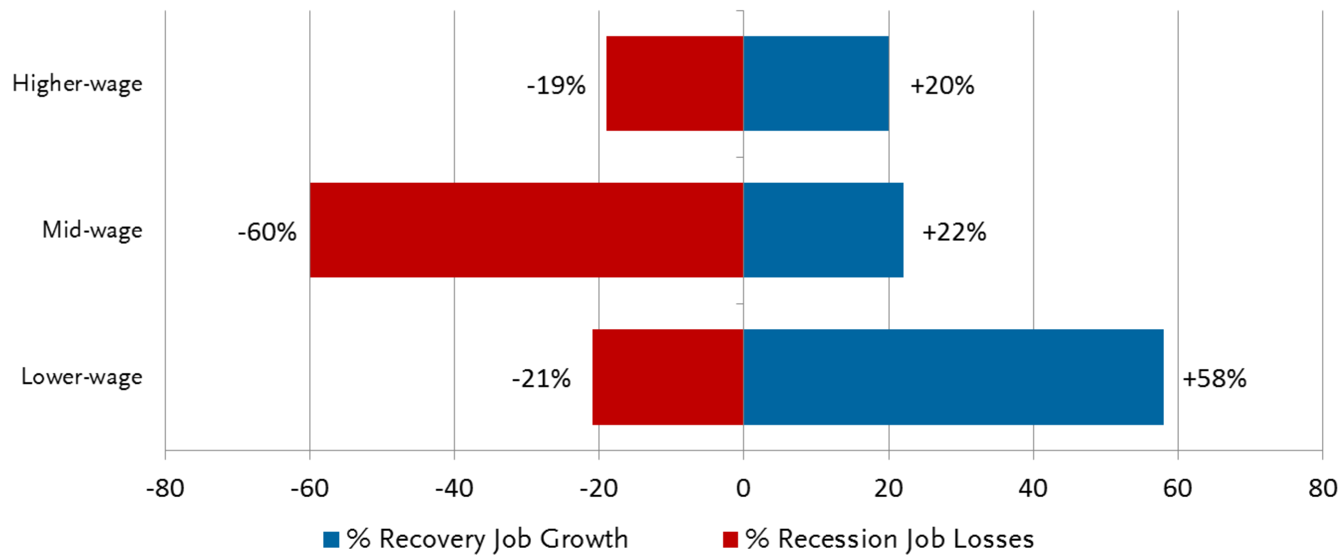
Finally, because of these large pools of private capital, an infrastructure investment program aimed at developing the energy, transportation, and water infrastructure needed to support the Middle American economy would be largely self-financing and would add little to the federal deficit. Unlike ordinary government expenditures, infrastructure investment creates new wealth and thus generates new tax revenues. Moreover, many of the infrastructure projects involved in building the public capital for the Middle American economy would generate user fees and other streams of revenues. Thus, regional government authorities and public-private enterprises would be able to issue bonds or raise equity capital at a relatively low cost. The overall cost to the government would therefore be relatively modest, and its long-term impact on the deficit could even be positive if it increases economic growth.

U.S policymakers, of course, should not limit the nation's public investment agenda to the rebuilding of our physical infrastructure. As is well understood in nearly all policy circles, investment in human capital is also critical to our longer term growth outlook. Again, what is important here is to highlight the economic logic behind a strategy of mobilizing global capital to strengthen America's human capital in support of a transition to a more balanced model of economic growth. Here three points are worth emphasizing.

First, we are experiencing changes in manufacturing that will make on-shoring increasingly attractive but that will require much higher levels of skills and training than in the past. Indeed, the developments in advanced manufacturing techniques and processes promise to completely flip the decades-long search for cheap labor in many parts of the manufacturing sector. Over the next decade or two, with the spread of mass customization and with the growing ability to undertake rapid platform shifts, it will not be cheap labor that determines where production is located but rather the closeness to the end-consumer and the availability of skilled workers.[34] These new manufacturing techniques will require much more training than past manufacturing jobs required, and thus there will be a need to integrate employment and education in ways that we have not done over the past several decades. Investing more in vocational and technical training – whether through community colleges or through German-style apprentice programs – will therefore become more important.

Second, the great economic as well as social challenge for the United States is how to generate jobs that pay middle class wages. Indeed, this is the key to a healthier pattern of economic growth over the coming decade. The hollowing out of the great middle caused by stagnant wages over the last several decades is one of the reasons for the explosion in private household debt, as families tried to make up for the lack of wage growth by borrowing or by tapping equity in their homes. Worryingly, the Great Recession has only exacerbated this trend. Over the past five years, it is estimated that 60 percent of the seven million jobs lost were in industries that pay middle class wages of $38,000 to $68,000 annually, while 58 percent of the jobs gained since the recession ended in June 2009 were in industries with low-paying positions (see **Figure 5**).[35] Investing more in human capital development will not alone correct this problem but it must be part of the solution.

Figure 5: Job Gains and Losses During Recession and Recovery



Source: National Employment Law Project

Third, while the United States has arguably the best demographics of all the advanced developed economies, we still face challenges relating to an aging population and slower population growth. An aging population means that we will have fewer new entrants to the workforce in the coming decades. We have two ways of countering this trend. One is to increase productivity to offset the slower growth in the workforce, which means a more educated and better trained workforce and thus more investment in human capital. The other is to increase immigration, especially of skilled workers.

That is why immigration reform is so timely economically as well as politically. One the main goals of immigration reform should be to ensure that more of the world's top students attending U.S. colleges and universities have an opportunity to stay in the United States following graduation.

An Inside-Outside Growth Strategy: Regional Integration

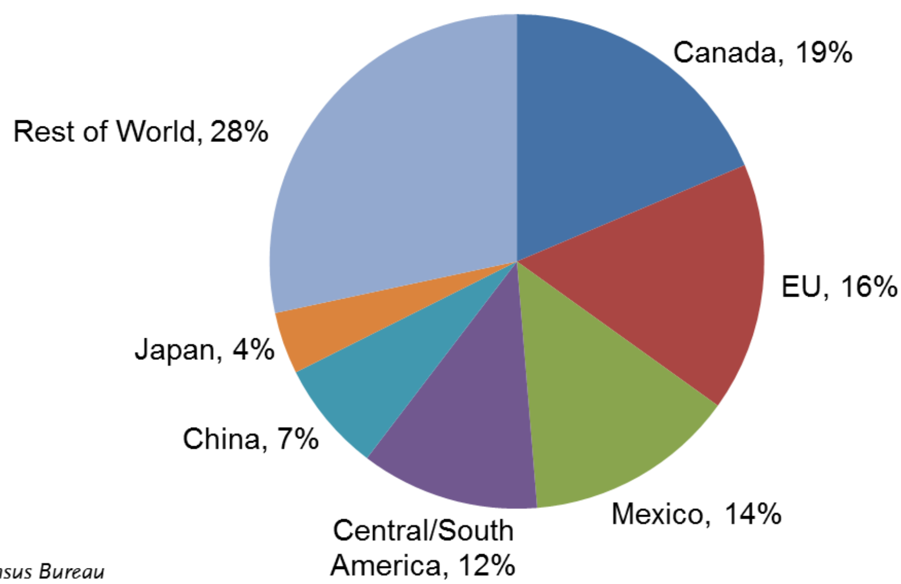
The emphasis on an internal public investment program does not mean that the United States can ignore the challenge of shaping trade and investment relations with other economies to support external demand and global growth. But as noted earlier, there will be limits to how much the U.S. economy can benefit from further integration with Europe and Asia given the nature of their transitions to new economic growth models. In the near to medium term, the most promising opportunities for increased trade and investment lie within our own neighborhood and hemisphere.

It may come as a surprise to some readers that U.S. exports to Central and South America (excluding Mexico) have increased from 8 percent of total U.S. exports in 2005 to 12 percent in 2012. That is just below the European Union, which accounts for 16 percent of U.S. exports (see **Figure 6**).[36] In other words, Latin America constitutes nearly as large as a market for U.S. goods as the much richer countries of Europe do. More important for U.S. international growth strategy in the future, the potential for a further growth in exports to Latin America far exceeds the prospects for increased trade with the recession-bound Euro-zone.

The conditions for stronger economic growth in the future are encouraging throughout most of Latin America, but they are especially promising in Mexico.

In contrast to the debt-burdened economies of Europe, Mexico has one of the world's best macroeconomic frameworks, and with a new government pursuing a widely supported reform program, there is good reason to believe that Mexico is on the cusp of a major consumer and investment boom. Mexico's 4 percent GDP growth last year was double its average of the prior decade, while new president Enrique Peña Nieto has committed his government to expanding Mexico's growth rate further to roughly 6 percent in the years ahead. Labor, tax and energy reforms could make a major difference, especially by opening up the energy sector, a move that would likely bring billions of dollars of foreign direct investment into the country. Because of the improvement in the Mexico economy, the flow of labor from Mexico to the United States has begun to reverse to the point where net Mexican immigration to the United States was flat in 2011.[37] Given current trends, it might not be too long before we hear "tear down that wall" in relation to the border between Mexico and the United States.

Figure 6: US Exports in Goods by Major Trade Partner



Source: US Census Bureau

With Mexico's resurgence, NAFTA has begun to emerge as the most successful of the regional integration efforts of the past two decades despite a number of hiccups and geo-economic detours along the way. And with Latin America having fully recovered from its earlier lost decades, it is time for the United States to build upon the success of NAFTA to develop the full potential of integration in the Americas. Taken as a whole, Latin America encompasses close to 600 million people, has a combined GDP of close to $6 trillion (which is 40 percent of the U.S. economy), and is projected to grow at a rate of just under 4 percent annually of the next five years, according to the IMF.[38] Given these projected growth rates, and given the potential synergies between the United States and many Latin American economies, it is reasonable to believe that South America can help the United States realize its export goals and offset weaker external demand from other parts of the world economy.

Within Latin America, there are three regional groupings that stand out: Brazil and its Mercosur partners (Argentina, Paraguay, Uruguay, and Venezuela) form a southern trading bloc; the free-trading Pacific economies of Mexico, Colombia, Peru, and Chile make up another; and the Central American states constitute a third. The most promising immediate prospect for increased trade and investment may come from the Pacific grouping given the conclusion of recent U.S. trade agreements with Colombia and Peru. But there are also promising trade and investment complementarities with other Latin American economies. As noted earlier, an internal U.S. growth policy driven by investment in physical and human capital could reinforce the prospects for deeper integration with Latin America. A major infrastructure program in particular would boost Latin commodity exports to the United States (and thereby hedge Asian demand risk for Latin America) and in turn stimulate Latin demand for U.S. exports in both goods and services. Immigration reform and a recasting of the border as an impediment to economic growth rather than a barrier to illegal immigration would reinforce our ties with our southern neighbors to the betterment of the U.S. economy.

Beyond this, trade and investment with Latin America would benefit from an expansion of regional and inter-hemispheric infrastructure. One such example is the Connecting the Americas project, which is designed to link the region's electric grid from northern Canada to southern Chile by 2022.[39] Another is leveraging the expansion of the Panama Canal to allow for bigger ships (due for mid-2015) and tying it into the economic expansion of the "Third Coast" of the United States on the Gulf of Mexico. Infrastructure development in Latin America is expected to continue to grow rapidly as countries try to cover a roughly $200 billion annual infrastructure investment gap.[40] One such project is the Interoceanic Highway connecting Brazil, Peru, and Bolivia and linking the Atlantic and Pacific coasts.[41]

Another promising area of opportunity lies in the export of services. U.S. financial, accounting, and other services firms stand to benefit from the further development of Latin America's financial markets. While developing rapidly, there are still small compared to Asia. As interest rates continue to fall, financial market development should take off, especially in Mexico, Chile and Brazil. Latin America has already had great success in the development of domestic pension and insurance funds, now approaching $1 trillion in assets under management.[42]

Pointing Globalization Toward A Brighter Future: The Tri-Polar World Economy 2020

An international strategy that seeks to reinforce the emerging success of NAFTA and extend it further into Latin America would serve a purpose beyond expanding external demand for U.S. economic growth. It would also offer a model for regional integration in other parts of the world economy and point the way toward a healthier and more balanced tri-polar world economy.

NAFTA has worked because it has incorporated three parts of a successful regional economy: a dominant consuming center (the United States); a relatively low-cost manufacturing platform (Mexico now accounts for 12 percent of U.S. imports, up from 8 percent in 1995); and a natural resource supplier (Canada). NAFTA will of course continue to evolve as the United States become more investment and production-oriented and develops its energy resources, and as Mexico grows richer and consumes more. Nonetheless, NAFTA offers a template the regional deepening in other parts of the global economy.

An international economic strategy aimed at deepening regional connections is the best way for the United States to reconcile its two overarching policy goals – putting the U.S. on the path to more robust balanced economic growth yet preventing the further collapse of globalization. America's strategy ought to be to encourage Europe and Asia to undertake comparable regional deepening processes to generate more of their own demand thereby making possible a truly tri-polar world economy by 2020.

A tri-polar 2020 global economy envisions a world in which each region (Americas, Europe and Asia) is able to generate more of its own demand and its own savings, enabling each region to operate in a more self-contained holistic fashion. Each region will be largely self-financed through bond and equity markets that leverage regional savings pools, thus reducing the imbalances caused by a few out-sized current account surplus countries; largely self-reliant in manufacturing as the rise of 3-D printing brings producers closer to consumers rather than to where the cheapest labor lies; and largely self-consuming as the Asian middle class develops, Europe regenerates, and the United States restores its job creating machine and as Latin America grows richer and becomes a larger consumer.

Embracing the goal of a tri-polar world does not mean that the United States would forsake trade and investment with other regions of the world economy or would not try to fashion global solutions where they are necessary. A tri-polar world economy would need to leave room for other poles to emerge. It would, for example, need to be able to accommodate a Middle East that expands beyond its historical role of energy exporter to become a capital provider and consumer. It would also need to embrace an Africa that continues to integrate into the global economy as a natural resource provider and increasingly as a consumer. It is not too far a stretch to suggest that by 2020 or 2030 we will be talking about a four-polar world as Africa takes its rightful place as a regional economic actor.

But in the near to medium term, our focus must be working our way out of the current global economic crisis. That means an international strategy that seeks to offset weak demand in Europe and Asia with internal demand at home, that seeks to put excess global capital to work rebuilding our physical and human capital, and that seeks to deepen regional integration in the Americas. If we do these things, we will have prepared the way for the next generation of prosperity at home and for a more balanced form of globalization in the world at large.

The author would like to thank Shirin Mohammadi for her research assistance.

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