Michael Pettis, *The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy*
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CHINA'S RISE STALLED?

It was perhaps predictable that China's initial sharp rebound from the global financial crisis would serve to entrench widespread perceptions that the PRC represents an alternative and, on some readings, superior model of capitalist development. Desperate pleas by Hillary Clinton and Tim Geithner for Beijing to continue its purchase of US Treasuries in the immediate aftermath of the 2008 meltdown seemed to confirm that China was indeed displacing the US, the alleged culprit of the crisis, and becoming a new centre of the global economy. Yet the celebrations of China's rise at the expense of the US evoked more sceptical responses too. Michael Pettis's provocative and well-informed new book, *The Great Rebalancing*, presents a more critical view. It contends that countries that run a persistent trade surplus, like China, are at least as responsible for the global financial crisis as those running deficits, like the US. In his view, the outcome of the crisis will put an end to the 'economic miracles' of the surplus countries and may lead them into Japan-style lost decades. The only way out would require a profound rebalancing of the surplus countries' economies. I will argue that a third scenario could be derived from the book's analysis, beyond Pettis's alternatives of a prolonged, deepening crisis or smooth, coordinated rebalancing. But first let us examine *The Great Rebalancing's* account.

Pettis is a professor of finance at Peking University and a veteran Wall Street wheeler-dealer specializing in 'emerging markets', initially in Latin America. His first book, *The Volatility Machine: Emerging Economies and the Threat of Financial Collapse*, appeared in 2001, and since then his contrarian views have become well known through his widely cited blog, 'China Financial Markets'. Drawing diverse theoretical insights from Keynes and, surprisingly, Hobson, Lenin and David Harvey, *The Great Rebalancing* is a systematic elaboration of Pettis's diagnosis of the origins of the financial crisis and suggestions for its remedy. He sees the global trade and capital-flow imbalances underlying the crisis as primarily a consequence of the consumption-repressing growth model adopted by the surplus countries, most notably China and Germany.

The Great Rebalancing sets out the principles at stake, in the form of 'accounting identities'. Where consumption is repressed relative to production, the result is a rise in saving. If domestic savings exceed domestic investment, then in an open economy the excess saving will flow abroad to other countries, in the form of net capital export. China's purchase of US Treasury bonds and Germany's lending to Spain and Greece are examples of such exports. Similarly, for a country that imports capital from abroad, investment will exceed saving. It follows that the amount of net capital outflow or inflow will be equal to the difference between savings and investment; the difference will also be equal to the country's trade balance. (Formally put, if Y is national product, C is total consumption, G is government spending, I is total investment, (X–M) is trade balance and S is saving, we have $Y=C+G+I+(X-M)$, which leads to $Y-C-G-I=S-I=(X-M)$, since, by definition, $Y-C-G=S$.) Therefore, an economy's trade surplus/deficit will be equal to that economy's net capital outflow/inflow, which in turn is equal to its saving less investment. As open economies are linked to one another through trade and investment, capital export and trade surplus originating from one country's under-consumption must be balanced by capital imports, trade deficit and over-consumption in another country. In other words, domestic imbalances of trading partners will mirror each other, generating global imbalances.

Examining how these principles have operated in the concrete case of China's domestic imbalance, Pettis, like many other authors, finds that the PRC's model of repressed-consumption growth is not new, but is an extended replication of the Japanese model. As Pettis emphasizes throughout the book, a country's consumption levels and savings rate have nothing to do with its culture and the habits of its people: China's high saving and low consumption are consequences of explicit policies: wage repression, an undervalued currency and financial repression. Since the 1990s, the vast supply of rural migrant labour, whose rights and access to services where they worked were denied under the *hukou* system, in addition to what Pettis describes as 'government-sponsored unions that more often see things from the point of view of employers than from that of workers', ensured that wages grew much more slowly than productivity, hence repressing the growth of workers' income and consumption relative to the growth of production. At the same time, China's central bank intervened in the currency market to prevent the yuan from appreciating alongside the growth of the trade surplus. The undervalued currency benefited exporters, but made domestic consumption more expensive; the policy has therefore operated as a hidden tax on household consumers, which is transferred to exporters. The low interest rates maintained by state banks for both depositors and borrowers have also constituted a hidden tax on households: while ordinary depositors have had to put up with meagre or even negative real interest rates, state enterprises and government units could borrow at give-away rates to fuel the orgies of real-estate and infrastructural construction. This again is tantamount to a subsidy to the state sector paid by financially repressed depositors.

This model of development brought about miraculous economic growth rates, rapidly improving infrastructure and an internationally competitive manufacturing sector. Paradoxically, though the growth rate has attracted high investment, the financial repression involved also pushes saving—here, mostly corporate and government rather than household saving—to an even higher level. As such, the excess saving of China has to be exported overseas in exchange for external demand for its manufactured products. Given the size of the US market and the high liquidity of US assets, Treasury securities in particular, most of China's excess saving ends up heading to the US. To Pettis, the Chinese purchase of dollar assets is a trade policy, 'aimed at generating trade surpluses and higher domestic employment'. For the American economy, such large-scale capital imports are 'usually harmful', as the US has 'no choice but to respond to the growing net inflows [of capital] with higher investment, higher unemployment, or higher consumption'. With capital inflows pushing up the dollar, cheapening manufactured imports and penalizing US manufacturers, 'there was little incentive for American businesses to borrow and expand production domestically'. Instead, the massive inflows of capital fuelled the expanding real-estate bubble and debt-financed consumption. Pettis concludes that the US consumption spree and trade deficit was caused by excessive foreign (Chinese) investment in dollar assets that '*force* Americans to consume beyond their means'.

In his analysis of the Eurozone crisis, Pettis sees the relation between Germany, a surplus country, and Spain and other 'deficit countries', as reminiscent of that between China and the US. In the 1990s, post-unification Germany put into place 'a number of policies, agreed on by trade unions, businesses and the government, aimed at constraining wages and consumption and expanding production, in order to regain competitiveness and generate jobs.' These consumption-repressing policies worked well. But excess saving has to be exported, in exchange for 'importing' external demand. In this instance, the context included the launch of the euro and increasing European integration. German capital was exported to peripheral

Europe principally in the form of bank lending, but its harmful effects resembled China's capital exports to the US in the form of buying Treasury bonds. Taking Spain as his example, Pettis contends that German's anti-consumption policies eroded the profitability of Spanish manufacturing and discouraged private investment in the tradeable goods sector there, while at the same time Germany's excess saving was being exported to Spain on a massive scale. The result was the expansion of a gigantic real-estate bubble in Spain.

Pettis reminds us that global imbalances caused by under-consuming countries which export surplus capital to other economies are not novel in the development of capitalism. Drawing from the insights of Hobson and Lenin, he notes that in the late nineteenth and early twentieth century, under-consumption in industrialized economies—where workers' demand was repressed since wealth and income were concentrated in the hands of the rich—created pressures for those countries to export capital to their formal or informal colonies, which in turn started to run trade deficits and be indebted to the colonizing countries. The main difference between then and now is that, in the early 1900s, capital-exporting colonizers 'managed the colonial economies and their tax systems, and so they could ensure that all debts were repaid'. Global imbalances could therefore last longer in the age of imperialism, as 'large current-account imbalances could persist for as long as the colony had assets to trade [or to be expropriated]'.

What Pettis does not mention is that a century ago, when colonized importers of capital were invariably underdeveloped economies, the imported capital mostly flowed into extractive industries instead of financial markets. This kind of investment did not generate the type of volatility that financial investment in today's deficit countries entails. On the other hand, this highly territorial form of capital export drove the imperial powers to vie aggressively with one another for colonial possessions, intensifying inter-imperial rivalry and triggering the First World War. Capital exporters today, like China and Germany, do not enjoy that sort of colonial control over importers of their capital, like the US and Spain, and much of it flows into financial and real-estate activities. Imbalances under these conditions are less sustainable. Once the bubbles burst, or borrowing capabilities run out in the increasingly indebted deficit countries, consumption there will collapse. This is what has been happening in the US, Greece and Spain since 2008. When this happens, trade-deficit countries are forced to undergo painful rebalancing, which can be achieved through tax hikes on the rich and/or policies that restrain consumption and boost saving. Such rebalancing efforts will be futile, however, if the surplus countries continue to repress consumption, export surplus savings and maintain trade surpluses with the deficit countries.

It is mathematically impossible for the US and peripheral Europe to attain trade surpluses and repress consumption if no other countries are shrinking their surpluses and boosting consumption. In the global economy, someone's surplus must be accompanied by another's deficit. A true rebalancing of the global economy is possible only when the deficit countries and surplus countries rebalance their domestic economies simultaneously through mirroring policies. America's and Spain's policies to restrain consumption and boost saving have to be accompanied by policies in China and Germany that boost consumption, reduce saving and reverse their trade balance. Pettis suggests that Germany should cut taxes and increase government spending to deflate its savings and move towards a trade deficit, generating demand for the tradeable goods sector in Spain and Greece. In that case, the latter's rebalancing policies, which restrain consumption and investment, would cause less unemployment. If Germany is reluctant to rebalance, then Spain's and Greece's adjustment may be so painful that they will be forced to default on their debt or devalue their currency by leaving the euro. Likewise, American rebalancing has to be accompanied by China's shifting in the opposite direction, if it is to be effective. The PRC needs to boost domestic consumption and reduce its saving. As China's under-consumption is mainly attributable to the squeezing of household income to subsidize export manufacturers and the state sector, boosting consumption will have to involve a 'distributional struggle' in favour of the household sector.

China's rebalancing is not only crucial to the rebalancing of the US and global economy, Pettis argues. It is also essential in order to prevent a serious economic crisis within the PRC itself. The two engines of the Chinese miracle—investment and exports—are starting to crumble. China's infrastructure is becoming excessive, relative to its stage of development, and falling returns on newly constructed infrastructure are exhausting the lending capability of the state sector, which is already overloaded with pre-existing loans. In the meantime, US consumption is declining and the concomitant political pressure on Beijing to shrink its trade surplus mounts. With the investment and export engines faltering at the same time, an increase in Chinese household income and consumption becomes all the more important.

The Great Rebalancing should be celebrated for its clarity and concision. It mounts a convincing challenge to mainstream moralizing about the origins of the global crisis, demonstrating that the global imbalances which underlie it unfold through a process of uneven and combined capitalist development, in which the US, China, Germany and peripheral Europe are interlinked parts. These merits notwithstanding, the analysis has two major gaps. The first of these centres on the origins of the imbalances themselves. If capital inflows from surplus countries are so harmful to deficit countries, fuelling financial and real-estate bubbles, then why do the latter keep letting the surplus capital in? Do the deficit countries really have no choice but to accept passively whatever the surplus countries are exporting to them?

Recall that the whole edifice of Pettis's argument is grounded on the accounting identity that a country's trade surplus equals its net capital export, as well as its saving less investment; yet as he states, this premise only applies to an 'open' economy. It follows that the analysis of the mirroring imbalances between surplus and deficit countries would not have been valid had it not been for the completion of global-market integration—the removal of numerous national controls. Such integration is far from the natural state of global capitalism. It is a result of the neoliberal project that Reagan and Thatcher started in the 1980s as a remedy for the crisis of falling profit rates across advanced capitalist countries in the 1970s. The creation of the WTO in 1994, China's accession to it in 2001 and the launch of the euro in 2002, deepening the integration of the European market, are major milestones of this project. The rise of a global integrated market makes the flow of goods and money feasible on a much vaster scale. Deregulation of financial markets in the US and Europe helped to ready these countries for the massive absorption of foreign capital as fuel for speculative activities. Viewed in this light, though high saving and the export-oriented model of growth in surplus countries is directly responsible for the imbalances in the deficit countries and the global imbalances at large, it was the neoliberal turn of the US and Europe in the 1980s that set the stage, enabling such growth models to work at all.

The second gap relates to the potential outcomes of the current global crisis, seen here as entailing either prolonged stagnation and 'lost decades', or coordinated rebalancing. Pettis is certainly right to assert that rebalancing within China, the biggest surplus country in the world today, would be very difficult, given the adamant resistance of the bureaucratic-capitalist elite, who are the major beneficiaries of the current model. What remains to be seen is whether China, faced with the limits to its model of exporting surplus capital to the US, yet resisting rebalancing, might choose to shift to a more 'classical' strategy of capital export—that is, to export capital to underdeveloped countries and invest mostly in extractive industries and infrastructure there. Though the stock of China's outward FDI flow so far amounts to less than 30 per cent of its holding of US Treasuries (or 10 per cent, if we exclude flows into Hong Kong), according to the PRC Ministry of Commerce it increased dramatically between 2002 and 2010, from \$29.9bn to \$317bn, or \$118bn excluding Hong Kong. China's outward FDI comprises a lot of investment in mining and infrastructure in the global South. The recipients of Chinese capital—and that from other emerging surplus countries, like Brazil and South Africa—also constitute expanding markets for Chinese manufactured exports. China's increasingly proactive economic expansion in the developing world, Africa in particular, has provoked heated debate. For example, on the eve of the BRICS Durban Summit in March 2013 Lamido Sanusi, Governor of Nigeria's Central Bank, wrote in the *Financial Times* that China is just another colonial power in Africa.

To be sure, China's relations with the other developing countries that absorb its exports of capital and manufactured goods are far from the classical colonial model of the early twentieth century. China has so far lacked the will and muscle to assert military and political influence over the destinations of its capital exports. But this seems to be starting to change, as China's latest National Defence White Paper, 'The Diversified Employment of China's Armed Forces', stated explicitly that protecting overseas economic interests is now a core goal of the PLA:

> With the gradual integration of China's economy into the world economic system, overseas interests have become an integral component of China's national interests. Security issues are increasingly prominent, involving overseas energy and resources, strategic sea lines of communication, and Chinese nationals and legal persons overseas.

Should China manage to develop its geopolitical prevalence in select parts of the global South, then Beijing might well be able to delay rebalancing and sustain its high-saving, high-export model of development by shifting from the US to the developing world as the major destination of its surplus capital and manufactured exports. Of course, China's rise as a new imperial power is at most incipient. The two alternative scenarios that Pettis contemplates—a smooth, coordinated rebalancing of the surplus and deficit countries or a long, rocky landing of China and Germany, following in the footsteps of Japan's lost decades—are still much more plausible in the short run. In any event, the global crisis starting in 2008 is a turning point in the development of global capitalism. In the long run, whether it will lead to a more balanced and sustainable world economic order, a perpetual global crisis, or a renewed partition of the world by old and new imperial powers remains to be seen.