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**Research Report**

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# GLOBAL ECONOMIC PROSPECTS: THE RECESSION MAY BE OVER BUT WHERE NEXT?

Yılmaz Akyüz



# RESEARCH PAPERS

26

## GLOBAL ECONOMIC PROSPECTS: THE RECESSION MAY BE OVER BUT WHERE NEXT?

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SOUTH CENTRE

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## I. ISSUES AT STAKE

After a deep and widespread contraction in economic activity and significant loss of output and employment, policy makers, financial analysts and media pundits all appear to be heartened by the news coming from different parts of the world that the worst is over. The main concern now is about the strength and the shape of the recovery – that is, whether there will be a sharp, V-shaped upturn that would recuperate most, if not all, output and employment losses incurred during the past two years or a sluggish, U-shaped, recovery wherein, despite positive growth, output will stay below its potential for some years to come and job creation will remain sluggish. In addition, there is of course the possibility of a double-dip or a W-shaped recovery that may result from inventory cycles or premature exit from stimulus packages.

Over the medium term hopes are for the global economy to go back to the kind of rapid and broad-based expansion enjoyed from the early years of the decade until 2008 without, however, the accompanying financial fragilities and trade imbalances. This optimistic scenario depends, to a large extent, on a measured rebalancing of the US and Chinese economies – the largest deficit and surplus countries, respectively. In view of the central place occupied by the dollar in the international reserves system, it is recognized that international monetary and financial stability crucially depends on spending discipline by the US, in line with its income, allowing for a fundamental and sustained balance-of-payments adjustment. However, in order to maintain growth, the US should not simply cut domestic absorption but also shift to export-led growth. An orderly US adjustment would also require, *inter alia*, a shift by China from export-led to consumption-led growth and the realignment of the exchange rate of the RMB against the dollar. In this way, prospects for global stability are expected to improve without sacrificing growth.<sup>2</sup>

Even if such a rebalancing proceeds smoothly, most developing and emerging economies (DEEs) are caught in a dilemma: they are damned if the US adjusts and damned if it does not. On the one hand, “business as usual” would expose them to recurrent currency and financial instability. On the other hand, retrenchment and adjustment in the US could cause problems on several fronts. It is likely to lead to tightened global financial conditions with negative effects on several DEEs that have structural external deficits and are hence dependent on capital inflows to sustain acceptable growth. More importantly, there is no other country that could act as a global locomotive. China cannot replace the US even if it maintained GDP growth of some 10 per cent based on domestic consumption rather than exports; its GDP is about one-third of the US, the share of households in GDP is much smaller, they save a much higher proportion of disposable income and the import content of household consumption is much lower than the US.

We thus need more than US-China rebalancing to sustain global stability and growth. While there has been almost exclusive focus on the US-China relation, a global restructuring of the pace and pattern of demand cannot exclude the two other

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<sup>2</sup> This was broadly the plan promoted by the IMF in its multilateral consultations to reduce global imbalances on the eve of the crisis. Although the crisis has resulted in sizeable changes in external positions and savings patterns, the Fund recognizes that imbalances are not a problem of the past and there is still a need to remove global imbalances; see Blanchard and Miles-Ferretti (2009)

major surplus countries, Japan and Germany. These countries have been siphoning off global demand without adding much to global growth and relying on exports to a much greater extent than China.

There is more, however, to global imbalances than macroeconomic geography. Income distribution has played an important part and should also be part of the solution. Market-driven globalization has systematically tilted the balance of economic power against labour and in favour of capital, as indicated by the falling share of wage income almost everywhere. The outcome has been under-consumption in all major surplus countries, notably China, Germany and Japan. The threat of global deflation has been avoided thanks to consumption and property surges financed by growing debt and capital gains brought about by rapid credit expansion and asset inflation, notably in the US but also a number of other advanced economies (AEs) and DEEs, particularly in Europe. This process has, in its turn, produced growing trade imbalances, large shifts in net asset positions of countries and increased financial fragility, culminating in the most serious post-war economic crisis.

The world economy now faces a serious dilemma: financial consolidation and retrenchment in deficit countries would raise the spectre of economic stagnation, while a return to financial bubbles and debt-driven expansions could mean that the next crisis may even be worse and the state in a much weaker financial position to respond effectively. But in either case, the adjustments exist only in appearance since, without restoring the balance between labour and capital, neither stability nor growth may be sustained for long.

There is thus a need for adjustment in the four major economies, the US, China, Japan and Germany with the aim of removing imbalances while ensuring adequate global demand without a return to financial bubbles and debt-driven spending. The US needs to live within its means. China, Germany and Japan all need to boost domestic consumption by reversing the downward trend in the share of wages in GDP. In the latter two countries this is needed in order to accelerate growth while in China it is needed to avoid a growth slowdown that may result from a deceleration of exports. Furthermore, China should not only accelerate domestic consumption but also increase its import content. All these need to be complemented with a reform of the global financial architecture so as to ease the payments constraints over deficit and indebted developing countries.

There are no signs that a reorientation of policies needed for such a rebalancing are on the agenda of the major countries or the international community at large. Consequently, the world economy generally and DEEs particularly may face more serious challenges in coming years than they have seen during the recent global downturn. The outcome could be sluggish, uneven and erratic growth, continued and even deepened instability in currency and asset markets, the rise of protectionism and economic nationalism, escalation of conflicts in the international trading system and a backlash against globalization.



## II. BUBBLES, EXPANSION AND IMBALANCES

The principal source of these difficulties is the US economy which has been driven by two back-to-back bubbles since the early 1990s. It entered the 1990s with a recession which had been deepened by a banking and real estate crisis (i.e., the so-called Savings and Loans crisis) produced by a combination of financial deregulation and deposit insurance in the previous decade. The response was a sharp reduction in interest rates which allowed debtors to refinance debt at substantially lower rates and banks to build up capital by arbitraging between the Fed and the Treasury – or riding the yield curve, as the markets would put it. This, together with advances in information technology, created the dot-com bubble in the second half of the 1990s, accompanied by a boom in the housing market (Baker 2008). The Fed refrained from applying the brakes even though its chairman recognized that financial markets were driven by "irrational exuberance" rather than economic fundamentals.

The housing bubble continued with even greater force after the bursting of the dot-com bubble in the early years of the 2000s, thanks in the first place to deliberate policy action by the Fed which responded to the collapse in equity markets by bringing policy rates to historical lows for fear of asset deflation and recession. Second, the collapse of the stock market made investment in property even more attractive. Finally, new legislation introduced in the late 1990s allowed greater room for banks to expand high-risk, speculative lending through securitization. All these combined to produce a massive credit expansion for property investment as well as for consumption.

These bubbles played a major role in the fall of household savings and the rise of external deficits in the US. The dot-com bubble generated a strong wealth effect on private consumption while financial deregulation and low interest rates facilitated household access to credit.<sup>3</sup> Rapid growth in private consumption was sustained by capital gains from rising house prices in the 2000s as homeowners increasingly extracted equity to finance consumption. As a result, household savings, which was some 6 per cent of GDP in the early 1990s started to fall rapidly and disappeared altogether on the eve of the 2008 crisis. This was mirrored by growing external deficits – the US current account was broadly balanced in the early 1990s, but it registered a deficit of over 6 per cent in 2007. This led to a massive accumulation of dollar liabilities abroad, undermining the stability and even the reserve-currency status of the dollar.

The exchange rate and reserve policies of surplus countries, notably China and Fuel Exporters (FEs), facilitated the surge in consumer lending and spending in the US during the sub-prime bubble while also helping their own exports. They pegged their currencies to the dollar and were content to invest a very large proportion of their surpluses in US Treasuries and the debt of government sponsored mortgage firms. Without such large inflows, credit expansion, the consumer spree and the property bubble could not have been sustained for long. The dollar and long-term interest rates would have come under strain and this would have made it difficult for

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<sup>3</sup> On the impact of capital gains from the dot-com bubble on household consumption, see Maki and Palumbo (2001), and on the impact of low interest rates on household debt, see Debelle (2004).

the US to pursue lax monetary and regulatory policies and keep on spending beyond its means.

Monetary conditions in Japan and Europe also added to global liquidity expansion from the early years of the decade. Policy interest rates were kept almost at zero in Japan under conditions of deflation and even the otherwise conservative European Central Bank joined in and lowered interest rates considerably. After a brief downturn the world economy enjoyed a period of exceptional growth until the outbreak of the crisis in 2008. Average global growth exceeded that of the 1990s by one-half while growth in DEEs was twice as fast as the 1990s, exceeding even the rates achieved during the golden age. World trade in dollars increased by 2.5 times during the same period and DEEs as a whole started to run growing current account surpluses which exceeded \$600 billion in 2007 of which two-thirds belonged to Asian DEEs and the rest to FEs. Search-for-yield in conditions of ample liquidity also redirected private capital flows to DEEs which rose from \$50 billion in 2002 to exceed \$600 billion. Twin surpluses on current and capital accounts allowed DEEs to accumulate large amounts of international reserves which increased fivefold to reach \$5.3 trillion at the end of 2008.

### **III. CRISIS, RECESSION AND RECOVERY**

This impressive global economic performance was followed by an equally impressive global economic downturn, second only to the Great Depression of the 1930s. While both the boom and bust originated in financial markets in advanced economies, and financial contagion has helped to spread the downturn, the main channel of transmission of the crisis to DEEs has been through trade. Despite widespread expectations of decoupling, more successful exporters dependent directly or indirectly on US and European markets, including China, Mexico, Korea, Taiwan, Malaysia and Singapore, have been hit much harder than countries with a better balance between domestic and external sources of growth such as India, Indonesia and Brazil.

The financial impact of the crisis on DEEs, unlike financially fragile European economies, has generally been quite “benign”. After the collapse of Lehman Brothers there was a period of rapid exit of capital from DEEs and sharp increases in risk premia on their sovereign debt, exerting heavy selling pressures on currencies and causing large drops in asset markets. However, with aggressive monetary easing in the US and sharp cuts in interest rates across the AEs generally, capital flows to DEEs soon recovered, driven to an important extent by dollar carry-trade (Roubini 2009). This, together with significant easing of monetary policy in several DEEs, including China and India, gave rise to bubbles in asset markets and put upward pressures on currencies and commodities. As in the early 2000s, policy responses to the bursting of a financial bubble thus gave rise to another one, but this time not in the US itself, but in the DEEs.<sup>4</sup>

The two economic powerhouses, the US and China, adopted the strongest policy response to the crisis. While the US fiscal package has focussed on tax cuts and transfers, China allocated some 15 per cent of GDP mainly to investment in infrastructure while spending a relatively small part on transfers to households. In both countries there has been aggressive easing of monetary policy. In the US this was designed mainly to bail-out troubled financial institutions and allow banks once again to build up capital by riding the yield curve. Until now, there has been little bank lending to households and business. In China, by contrast, monetary easing led to a rapid expansion of credit which, together with government policies designed to revive real estate demand, has created a bubble in the property market.

On the basis of the most recent evidence global recovery appears to have started around the second half of 2009. In most projections, every single major economy is expected to register positive growth in 2010 and the IMF (2010) has raised its projections for global growth to 2.9 per cent. However, these are all subject to the usual caveat about downside risks, particularly those that could arise from a premature exit from stimulus programmes.

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<sup>4</sup> However, as pointed out by the BIS (2010) the bubble appears to have run out of steam at the beginning of 2010 with equity prices falling and credit spreads widening on risky assets as a result of unevenness of global economic recovery and increased concerns about sovereign credit risk in Europe.

There is, however, a certain degree of ambiguity regarding what is meant by exit. It can refer to two different things; ending or reversing reflationary measures. In the former sense exit would mean no more cuts in interest rates or quantitative easing on the monetary front, and no new cuts in taxes and increases in discretionary spending on the fiscal front. In the case of reversal, there would be monetary tightening and interest rate hikes and fiscal consolidation designed to reduce structural budget deficits.

Central Banks have ended interest cuts in almost all major developing and developed economies. In major AEs there are some signs of monetary tightening, with the US Fed raising the interest rate it charges on short-term loans to banks. In several DEEs, including China, monetary tightening has started as interest rates and/or banks reserve requirements are raised gradually with the upturn in growth. On the fiscal side there appears to be no plans for new packages. But fiscal retrenchment is still not yet anywhere in sight.

Even without a monetary and fiscal policy reversal, the current recovery may be followed by another dip if stimulus programmes do not lead to sustained increases in private spending. Indeed, the 1990s witnessed several failed fiscal pump-priming attempts in Japan in conditions of financial fragility whereby recovery stalled when fiscal injection came to an end. Such an outcome cannot be entirely ruled out in the current recovery. In the US consumers have been constantly retrenching and deleveraging in response to a significant deterioration of their balance sheets resulting from some \$12 trillion loss of asset values, with household savings moving rapidly in to positive territory. So far much of the increase in consumer spending has been due to one-off effects of transfers (cash-for clunkers, food stamps, extended unemployment benefits etc.) and tax cuts. With bleak job prospects and continued consumer retrenchment, the strength of recovery seems to hinge much more on exports than consumption.

In China consumer spending held up during the sharp decline in growth, but it has not provided much impetus to offset the sharp decline in exports. On various estimates, between 80 and 90 per cent of Chinese growth in 2009 was due to investment, with the investment ratio climbing to 50 per cent.<sup>5</sup> While largely offsetting the deflationary impact of the decline in exports, the investment boom resulting from fiscal and monetary expansion has added to excess capacity already apparent in various sectors. This is likely to become more pervasive if exports do not pick up as stimulus packages fade away since the share of consumption in GDP is not expected to register a significant increase. Chinese exports expanded at double digit rates at the end of 2009 but slowed down in early 2010. Should exports fail to resume their strong expansion, growth in 2010 may not reach its 2009 level. But an aggressive exports push by China could deepen the trade frictions it has already faced not only with the US and the EU but also with other DEEs including India and Indonesia.

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<sup>5</sup> See Wolfe and Ziemba (2009) and Ho-Fung (2009).

#### **IV. NO RETURN TO “BUSINESS AS USUAL” – NEED FOR US ADJUSTMENT**

While it is generally agreed that a premature policy reversal in major AEs could tip the world economy back into recession, there are also concerns that a delayed exit might be highly damaging and could even lead to a deeper and more pervasive crisis. Near-zero interest rates and rapid liquidity expansion, if continued too long, would imply increased financial fragility in several DEEs which have been receiving large amounts of arbitrage capital and carry-trade flows in search of high returns, as in the period preceding the crisis. For the US there are concerns that these, together with large fiscal deficits and growing public debt, could eventually give rise to considerable increases in long-term interest rates because of rising inflation expectations, thereby reducing growth.

Perhaps a more important threat to stability and growth concerns US external deficits and the dollar. Even if, as expected, consumers continue to deleverage and reduce debt by keeping consumption below income growth, the US economy can start running higher external deficits along with growing budget deficits, which could both, on current trends, reach double digit figures as a proportion of GDP by the end of the decade. These twin deficits could place considerable pressure on the dollar, particularly if surplus countries are no longer eager to finance its deficits, and the US economy may end up facing an external constraint for the first time in its post-war history, unable to maintain a position of benign neglect towards the dollar. If, on the other hand, surplus countries resume the policy of “official settlement” of US deficits by investing their surpluses into US Treasuries, we would be back to business as usual, with attendant consequences for global stability.

Short of another bubble in asset prices and continued near-zero interest rates, US household spending over the next several years is expected to rise more slowly than disposable income, and the personal savings rates may reach 10 per cent, unprecedented in recent decades.<sup>6</sup> Pressures from the bond market are likely to force a US fiscal adjustment, particularly if combined with pressures on the dollar in the absence of a strong support from surplus countries. The cost of decade-long bubbles and aggressive monetary and fiscal policy responses to crises triggered by the bursting of these bubbles could thus be below-potential growth in the US for several years to come. This would bring an external adjustment through import cuts. But it would also imply a significant slowdown in the global locomotive that has been pulling many export-oriented DEEs.

Ideally, US fiscal adjustment should take place in the context of growth, as under the Clinton presidency, but without bubbles. With consumer retrenchment, this would depend very much on exports— that is, a shift from consumption-led to export-led growth. If successful, import cuts would then be avoided and external adjustment would be achieved primarily by expansion of exports. But this would require faster expansion of domestic demand in surplus countries, including DEEs and lesser reliance of other DEEs on the US market.

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<sup>6</sup> On US consumer adjustment in the coming years, see Glick and Lansing (2009).

A shift to export-led growth is what the US administration is now aiming at. The main objective of the National Export Initiative (NEI) launched by President Obama in his State of the Union Address is to double exports in five years to support job creation.<sup>7</sup> This will require 15 per cent growth per annum. This would mean a significant acceleration from past performance. According to a research note by Goldman Sachs, over the past 25 years it took an average of 11 years for exports to double. However, there were also periods where the US achieved rapid export growth. This includes two episodes during the inflationary 1970s when exports doubled within 5 years as well as the late 1980s when it took 7 years to achieve a similar increase. Since 2000 US exports have grown by some 11 per cent per annum in dollar terms – imports and hence the trade deficit have also grown roughly at the same rate. During 2006-08, export growth reached some 13 per cent per annum, almost double the rate of growth of imports. A target of 15 per cent growth per annum is very ambitious but not unreachable and would bring significant improvement in the US trade balance even if the past pace of imports is maintained.

The details of the NEI do not seem to have been fully worked out but certain features emerge from recent pronouncements. First, there will be considerable government support in the form of technical assistance for exporters, notably small firms and farmers, market research and credit provision. In a way the US appears to be shifting to a form of industrial policy for export promotion, after many years of opposing any such intervention – an initiative reminiscent of general export promotion policies pursued in Japan through JETRO (Japan Export Trade Promotion Organization) and in the Republic of Korea through KOTRA (Korean Trade Promotion Corporation).

Second, there is emphasis on greater market access abroad. In this respect, the plan calls for, on the one hand, strict enforcement of US trade laws against restrictive and unfair practices by its trading partners and, on the other hand, promotion of greater reciprocal market access through bilateral and multilateral agreements, including through the Doha Round.

Third, agricultural exports are among the areas where considerable progress is envisaged. But these are not expected to be doubled over the next five years. Indeed, such a rapid growth of agricultural exports cannot be achieved without retaining large subsidies and prising open the markets of DEEs. Such an attempt would certainly face stern resistance from DEEs with weak agriculture and kill any chance of the Doha Round coming to a successful conclusion.

Finally, a weak dollar does not appear to be a key element of this strategy. However reference is made to enforcement of US trade laws against unfairly priced imports which implies that sanctions can be sought against countries considered as manipulating their exchange rates to gain competitive advantage. This could be particularly problematic since such sanctions do not come under existing multilateral disciplines, either in the WTO or the IMF.

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<sup>7</sup> For the information used in this section and more details, see US Department of Commerce (2010), Thomson Reuters (2010) and Yang (2010).

US fiscal and balance of payment adjustment and monetary tightening could also mean considerably tightened global financial conditions compared to years before the outbreak of the crisis. It may bring significant increases in interest rates and exert strong adverse effects on international debtors and countries dependent on foreign capital flows. It is also likely to lead to an unwinding of dollar carry-trade and associated outflows from DEEs, pushing the dollar up and exerting downward pressure on currencies in several deficit DEEs as well as on commodity prices which tend to move inversely with the exchange rate of the dollar.<sup>8</sup> This likelihood is further increased by the financial turmoil in the eurozone. Indeed, contrary to widely held expectations, the years ahead could well witness the demise of the euro, rather than the dollar, given that sovereign debt problems are no less serious in the eurozone than in the US and that the region lacks effective institutional arrangements to address financial difficulties of member countries, as seen in the present crisis.

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<sup>8</sup> On the possible impact of dollar carry-trade on assets and currencies, see Pineda *et al.* (2010).

## V. CHINA TOO NEEDS TO ADJUST, BUT IT CANNOT BE A GLOBAL LOCOMOTIVE<sup>9</sup>

External adjustment in the US and slow growth in Europe will no doubt be problematic for China because of the important contribution that exports to these markets have made to its rapid growth. It is true that the average domestic value-added content of Chinese exports is not much more than half of their total value and the rest are accounted for by foreign value-added, mainly imported inputs from Japan and the DEEs linked to Sino-centric East Asian production network. Still, in the years before the crisis, exports accounted for about one-third of Chinese GDP growth thanks to their phenomenal expansion of some 25 per cent per annum – that is, more than three times the world trade volume and domestic consumption and twice as rapid as domestic investment (Figure 1). The contribution of exports to growth goes up to 50 per cent if spillovers to domestic consumption and investment are taken into account.

China cannot keep its exports growing at similar rates and continue to increase rapidly its penetration in markets abroad at a time when growth in the US and Europe is below potential, unemployment remains high and sticky, and reduction in global imbalances is seen as the key to global stability. An aggressive export push could face stern resistance with attendant consequences for the stability of the international trading system. If, on the other hand, it cuts the rate of expansion of its exports to a more acceptable level, then, without a fundamental change in the pace and pattern of domestic demand, its growth may barely reach 7 per cent. Growth may drop a lot more if the credit-driven investment bubble bursts, exposing bad loans and giving rise to difficulties in overstretched banks and, eventually, a financial crisis.

If the aim is to maintain pre-crisis growth rates of 10 per cent or more, the solution is naturally to raise domestic consumption much faster than has been the case so far; accelerating domestic investment to close the demand gap, as done during 2008-09, would simply aggravate the problem. Since the early years of the decade private consumption has been growing by 2.5 percentage points less than GDP and 5 percentage points less than investment (Figure 1). As a result, the share of consumption in GDP fell from 55 per cent in the late 1990s to some 36 per cent. This downward trend in the share of consumption in GDP would need to be reversed, with consumption growing faster than both income and investment.

Contrary to widely held belief, under-consumption in China is not the result of exceptionally large household savings. Chinese household savings as a proportion of GDP are not much greater than those in other DEEs at similar levels of development. Rather, under-consumption is due to a low share of household income and a high share of corporate income in GDP. A very large proportion of household earnings in China consist of wages since government transfers and investment income are very small. The share of wages in GDP has been constantly falling since the late 1990s – from 53 per cent to 40 per cent – and this is perfectly mirrored by the declining share of private consumption (Figure 2). With the continued rise of profits, corporate retentions and investment, including by state-owned enterprises, have come to exceed

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<sup>9</sup> This section draws on Akyüz (2010) which contains detailed discussion of export dependence of growth in China and DEEs in the Sino-centric East Asian production network and the sustainability of export-led growth.



20 per cent of GDP – far higher than the rates seen during the earlier industrialization of Japan and the newly-industrialized Asian economies.

Thus, the disparity between consumption and investment and the consequent dependence on foreign markets is a reflection of the imbalance between wages and profits, and between household and corporate incomes. This needs to be rectified if rapid and sustained growth is to be attained based on domestic consumption. This calls for higher wages and elimination of the gap between wage and productivity growth, significantly increased budgetary transfers, notably to rural households, and increased public spending on health, education and housing in order to reduce household precautionary savings.

However, a shift by China from export-led growth to consumption-led growth would not be of much help to other DEEs. This is because China is a major importer, but not a major market. Its imports from other DEEs are mostly in intermediate goods, including parts and components, used for exports of finished goods, mainly to the US and Europe, rather than for domestic consumption. The import content of Chinese exports is around 50 per cent. In recent years, over 60 per cent of imports were used directly or indirectly for exports and less than 40 per cent for domestic investment and consumption. Compared to consumption, investment draws in relatively large quantities of imports of intermediate inputs from other DEEs, as seen during the 2008-09 investment boom generated by the policy response to the crisis. By contrast, import intensity of Chinese consumption is very small, less than 8 per cent. Consequently, a \$100 shift in the composition of aggregate demand from exports to domestic consumption would reduce Chinese imports by some \$40.

Since over 60 per cent of all intermediate imports of China come from other DEEs, a shift from exports to the US and the EU to domestic consumption would lead to a significant drop in the exports of DEEs to China. This indirect exposure to a slowdown in Chinese exports to the US and the EU is particularly high among East Asian suppliers of parts and components: for every \$100 worth of processing exports of China to the US and the EU, about \$35-\$40 accrue to East Asian DEEs. These economies have also direct exposure since the US and the EU together account for more than a quarter of total exports of some of these countries. Japan is also among the countries most exposed to a shift of China from exports to the US and the EU to consumption-led growth since it provides over 15 per cent of China's total intermediate imports.

The import content of private consumption in the US is three times that of China. Thus, the reduction in US imports that could result from a \$100 cut in domestic consumption would be 3 times the increase in Chinese imports that would be generated by an additional \$100 worth of consumption. Furthermore, unlike China, the import content of exports in the US is lower than that of private consumption so that a shift from consumption to exports would reduce its total imports.

These imply that a shift from export-led growth to consumption-led growth in China and a shift in the opposite direction in the US would reduce aggregate imports of these two countries from the rest of the world. In other words, a US-China rebalancing would remove the demand stimulus that the US has been providing to

DEEs directly or through China without replacing it with adequate stimulus from consumption-led growth in the latter country.

For DEEs looking for export-led growth, China is not a good substitute for the US. Its consumer market is considerably smaller not only because of lower aggregate GDP and higher personal savings rate, but also because of a lower share of household income in GDP. Even if household income and consumer spending is raised considerably, exports to China would still be limited by its very low propensity to consume foreign goods, directly or as inputs into the production of domestic consumer goods and services. For China to become a major market for other DEEs, it should not only increase household income and consumption, but also consume more foreign goods. But even then the benefits may not all go to DEEs since China is clearly among the top markets to be tapped by the US in the context of its NEI.

## VI. BRINGING IN THE BYSTANDERS: GERMANY AND JAPAN

In the debate on global stability and growth attention is often focussed exclusively on US-China rebalancing, to the neglect of the role that could be played by two other major economies, Germany and Japan. These countries, like China, have been running large amounts of current account surplus which reached \$250 billion in Germany and \$210 billion in Japan before the onset of the crisis compared to \$370 billion in China.

A major reason why inadequate attention is paid in global rebalancing to these two major AEs is that their bilateral trade surplus with the US is much smaller than that of China; on the eve of the crisis it was some \$50 billion in Japan and \$75 billion in Germany against \$270 billion in China. However, the conventional measure of bilateral trade balance is highly misleading when countries' exports to each other have widely different foreign value-added contents. China's exports to the US contain a lot more foreign value-added than exports of the US to China. For instance, in conventional terms the trade surplus of China with the US was estimated to be some \$172 billion in 2005, while in domestic value-added terms (that is, when foreign content of exports of both countries is excluded) this figure comes down to less than \$40 billion (Lau *et al.* 2006). In the same year Japan's surplus with the US was around \$85 billion. Since the foreign content of Japan's exports is much lower than the foreign content of US exports, in value added terms Japan's bilateral surplus with the US turns to be higher than the bilateral surplus of China with the US. German exports also have higher foreign contents than US exports, but not as much as Chinese exports. Therefore, even though China's bilateral surplus with the US in value-added terms is higher than the bilateral surplus of Germany with the US, the difference is not as high as that indicated by the conventional measure.

More importantly, Japan and particularly Germany have been siphoning off global demand without adding much to global growth. During 2004-07, exports grew 12 times faster than domestic demand in Germany and 6.5 times in Japan while this figure was 2.5 for China (Table 1). As a result, in Germany GDP growth exceeded growth of domestic demand by a factor of 2.4. Consumption barely increased and its share in income fell while the share of exports rose. More significantly, despite the widespread hype about dependence of Chinese growth on exports, in both Germany and Japan, the contribution of exports to growth was much higher. In China about one third of GDP growth was due to exports compared to one-half in Japan and some 90 per cent in Germany.<sup>10</sup>

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<sup>10</sup> For the methodology used for estimating the contribution of different components of demand to growth, see Akyüz (2010).

This lack of dynamism in domestic demand in general and consumption in particular is due to stagnant or falling real wages and slow employment growth. In all major AEs wages have been sluggish since the mid-1990s, including the 2002-07 economic expansion, and the share of wages in income fell as real wages lagged behind productivity growth (Sommer 2009). In the US, despite the downward trend in the wage share, private consumption surged, sustained by asset bubbles, credit expansion and household debt. This has not been the case in Japan and Germany. Consequently, in both countries, notably in Germany, as in China, the decline in the share of consumption followed the decline in the share of wages in GDP (Figure 3). Unlike China, however, falling shares of wages and consumption in GDP have not been associated with strong growth in real wages, consumption and GDP. Naturally the correlation between wages and private consumption in AEs is not as strong as that in China because of greater private holding of income-earning assets and easier access to credit. Still the resemblance between Figure 2 and Figure 3, particularly for Germany, is remarkable.

In Germany, there are several reasons for high unemployment, slow growth of jobs and stagnant wages. First, reflecting largely the German aversion to inflation, the European Central Bank has focussed almost exclusively on price stability to the neglect of economic growth and conditions in the labour market. Second, the accession of several low-wage Central and Eastern European countries has led to significant outsourcing by German firms, which has not only intensified the pressure on the labour market in Germany but also served to restrain investment at home. Finally, orthodox labour market and welfare reforms have considerably weakened the bargaining power of the workers, particularly at the lower end, without creating many jobs.<sup>11</sup>

Wage restraints in Germany have been part and parcel of an attempt to increase competitiveness of the economy by reducing production costs – a policy described as “competitive disinflation” whereby the competitiveness gap is closed through falling productivity-adjusted real wages and prices (Fitoussi 2006). Greater competitiveness has thus come at the expense of consumer demand. However, export acceleration has failed to compensate the deceleration in domestic demand and GDP growth has remained sluggish.<sup>12</sup> More importantly, this has amounted to a beggar-thy-neighbour policy for several European economies locked in the euro but unable to restrain wages to the same extent, notably Italy and France. It has therefore threatened growth and stability in the eurozone as a whole, leading to strong exchanges between Germany and France in recent weeks.<sup>13</sup>

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<sup>11</sup> On “reforms” and labour market conditions in Germany, see Carlin and Soskice (2008) and Boltho and Carlin (2008).

<sup>12</sup> Domestic demand in Germany grew, on average, by 2 per cent per annum in the 1990s compared to 0.3 per cent in the present decade and GDP growth fell by one percentage points between the two decades.

<sup>13</sup> See *Financial Times*, Lagarde Criticises Berlin Policy, March 14, 2010; and *Wall Street Journal*, German Government Counters Lagarde’s Export Critique, March 15, 2010.

In Japan, the gap between wage and productivity growth has been greater than most other AEs so that the share of wages in GDP fell faster. As a result, the share of labour income converged to the G7 average, from considerably higher levels in previous decades. Increased competition from low-cost DEEs has led to outsourcing and exerted pressure on wages at home. Labour market deregulation from the mid-1900s onwards allowed greater space for employers to move away from the traditional practice of long-term employment where wages tend to rise with the tenure, towards lower-wage, temporary employees (Sommer 2009).

Like China, an increased contribution of Japan and Germany to global demand calls for faster expansion of domestic consumption which, in turn, depends on faster growth of labour income than has been the case so far. Unlike China, this is needed in Germany and Japan not so much to replace external sources of growth with domestic demand, but to raise the overall growth rate of the economy. Even with an unchanged rate of expansion of exports, a more rapid growth of domestic demand in these countries would naturally lead to a faster growth of imports and hence reduced trade surplus, thereby increasing their contribution to global growth.

## VII. EXCHANGE RATE ADJUSTMENTS

According to a view widely held in the US, the dollar is overvalued against the Chinese RMB by some 20-40 per cent because of currency “manipulation” by China, and this is the main reason for the trade imbalance between the two countries. On this view, if China stops intervening in the foreign exchange market and allows its currency to float freely, it will rise against the dollar, reducing the US-China bilateral deficits. It is argued that the reluctance of China and other East Asian DEEs to allow their currencies to appreciate against the dollar and the consequent persistence of their trade surpluses vis-à-vis the US place an undue burden on countries with freely floating currencies. This is particularly true for the euro, given the large volume of trade between the US and Europe. While the correction of the trade imbalance between the US and Germany may require the dollar to be weak against the euro, the rigidity of East Asian currencies could result in overshooting of the euro against the dollar, with attendant consequences for international monetary stability.

There can be little doubt that correction of blatant currency misalignments is an important element in the adjustment of global trade imbalances. However, currency movements do not create additional demand for the global economy as a whole, but simply serve to redistribute demand impulses across countries. The result will simply be to alter relative growth rates, rather than raising the overall global growth. Briefly, currency movements cannot address the problem of global under-consumption associated with sluggish wages.

A depreciation of the dollar against the RMB and the currencies of other East Asian DEEs will no doubt make Asian goods more expensive in the US, and this itself could reduce exports and trade surpluses in Asian countries. However, this would not solve the problem of under-consumption in China and automatically bring an increase in domestic demand to offset the decline in exports. The outcome is likely to be a reduction in growth and imports destined to exports. Appreciation against the dollar can even aggravate the under-consumption problem to the extent that the burden is passed onto wages. For these reasons, the exchange rate is not an appropriate instrument to address the problem of under-consumption and excessive reliance on exports in China.

This is also true to a large extent for the exchange rate of the dollar against the euro and the yen. Appreciation of the euro would not generate higher wages and faster growth of private consumption in Germany. Indeed, it could simply give rise to further wage restraint through “competitive disinflation”. It is interesting to note that both Germany and Japan have often been able to run trade surpluses in the aggregate and bilaterally against the US during the past several years irrespective of the strength of their currencies.

It is not clear how dollar depreciation against the RMB would address the root cause of the US problem of over-consumption. It is unlikely to produce a significantly faster growth of exports to China given that the import content of Chinese domestic consumption is small and Chinese imports for investment are closely tied to exports. On the other hand, even if it reduces China’s exports to the

US, this may be replaced not so much by domestic production in the US as by imports from other DEEs as long as US consumers continue to live beyond their means.

The US has been constantly running current account deficits in the past four decades regardless of the strength of the dollar against the currencies of its principal trading partners, blaming Germany in the 1970s, Japan in the 1980s and now China. The yen has been on a rising trend against the dollar during this period, but this has effectively had no impact on the surplus of Japan with the US. Nominal exchange rate changes cannot bring solutions to imbalances resulting from large inter-country disparities in thrift and productivity. The US needs to restrain profligate and irresponsible lending and consumption and improve its exports performance while surplus countries need to address under-consumption.<sup>14</sup>

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<sup>14</sup> In a recent interview the IMF Chief Economist, Oliver Blanchard, has argued that the appreciation of the RMB is not a panacea for the US. According to an IMF model a 20 percent appreciation in the RMB and the currencies of other East Asian DEEs would increase the US GDP by about 1 percent, “not enough, by itself to sustain growth in the United States” (Xinhua 2010).

### **VIII. REMOVING THE DEFLATIONARY BIAS IN THE INTERNATIONAL FINANCIAL ARCHITECTURE**

While several AEs and DEEs with strong industrial and export potentials are looking for markets, a number of DEEs are unable to import goods and services as much as required to satisfy the basic needs of their population, reduce poverty and sustain acceptable growth because of foreign exchange shortages even though these are among multilaterally agreed development objectives, notably in the MDGs. These include not only small economies almost entirely dependent on commodity export earnings, but also large, populous countries with some degree of progress in industrial development. This coexistence of glut in more advanced economies and unsatisfied needs in poor countries is a reflection of the failure of the multilateral system, notably the international financial arrangements, in providing the necessary financing to the latter. Consequently, reform of these arrangements should be an important part of post-crisis global restructuring for greater stability and sustained and broad-based growth.

The coming years may see payments constraints in the developing world becoming tighter. During the pre-crisis global expansion many DEEs succeeded in raising growth while keeping their current accounts broadly in balance or running moderate deficits. This included not only several poor commodity exporters in Africa and elsewhere but also some large emerging economies such as Brazil and India. In a few emerging economies in Central and Eastern Europe and Africa receiving massive inflows of capital, growth was associated with sharp currency appreciations and large and growing deficits which these inflows more than covered.

Global economic conditions in the coming years may not allow the repeat of this experience. Returning to pre-crisis growth rates under conditions of a slowdown in exports would require faster growth of domestic demand which would, in turn, mean larger external deficits. A tightening of global financial conditions could make financing of these deficits difficult and onerous, thereby necessitating retrenchment in domestic absorption and cuts in growth.

The areas of reform needed are well known, widely discussed after almost every major financial crisis, only to be forgotten subsequently with economic recovery. First, there is a need for greatly increased, stable and predictable development financing for countries lacking adequate domestic resources for an acceptable growth rate in order to make a dent in poverty and close the income gap with richer countries. In this respect we should move away from current arrangements where provision of such financing depends on the whims of the donors who serve their own interest rather than those of the poorest countries and communities. Since poverty reduction has been declared a global public good in several UN summits and conferences in recent years, there is a strong rationale for establishing global sources of development finance. This could be achieved through agreements on international taxes, including currency and financial transactions taxes, environmental taxes and various other taxes such as those on arms trade, to be applied



by all parties to the agreement on the transactions and activities concerned and pooled in a UN development fund.<sup>15</sup>

The second major area of reform concerns provision of international liquidity at times of trade and financial shocks to enable countries to pursue countercyclical macroeconomic policies so as to minimize loss of output and employment. This should address the two major shortcomings in crisis lending by the IMF. First, the Fund has traditionally been much more willing to provide financing to keep countries current on their debt and maintain open capital accounts than to finance imports and support trade, employment and growth. Second, crisis lending is often associated with pro-cyclical policy conditionalities which only serve to deepen the deflationary impact of shocks. The practice during the current crisis is not an exception in these respects. A new facility, Flexible Credit Line, has been established for emerging economies deemed eligible on the basis of some predetermined criteria in order to enable them to finance large and persistent capital outflows while poor countries have been kept on a short leash for trade and current account financing.<sup>16</sup>

The final important area of reform in this respect concerns sovereign debt to official creditors, both multilateral and bilateral. Despite repeated initiatives several poor countries continue to suffer from debt overhang, struggling to service unpayable debt, thereby diverting budgetary resources and foreign exchange away from development. The main problem here is that there are no impartial debt workout mechanisms and the assessment of debt sustainability is left to creditors, notably the IMF. Sustainability is often judged on the basis of how much debt and debt servicing a country can tolerate without paying adequate attention to its implications for development and poverty, and debt servicing is given primacy over all other economic and social objectives.

A consensus appeared to emerge among the major players in the early months of the current crisis on the need for reform of the international financial architecture in these and many other areas. A number of *ad hoc* initiatives have been launched and proposals put forward in various fora including the United Nations, the Group of 20 and the Bretton Woods Institutions. So far no definitive commitment has been made nor action taken to resolve any of these issues. The past record in this respect is not very encouraging. Despite a wide agreement on systemic reform to bring more effective governance to international finance after a series of crises in emerging economies in the 1990s and proliferation of proposals for reform, the *Financing for Development* initiative launched at the UN Conference in Monterrey in March 2002 has yielded no significant outcome in this respect. It is particularly up to developing countries to secure that this is not the fate of the ongoing process initiated in the UN in the June 2009 *Conference on the World Financial and Economic Crisis and its Impact on Development*.

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<sup>15</sup> See Atkinson (2005) for a menu of new sources of development finance.

<sup>16</sup> For further discussion of these issues various proposals for reform, see Akyüz (2009); and for IMF programmes in developing countries during the current crisis, see Weisbrot *et al.* (2009).

## IX. CONCLUSIONS

Globalization has tilted the balance between labour and capital against the former. Closer integration of China and India into the global economy and the collapse of the Soviet Union have doubled the global labour force and tripled the total number of workers producing for international markets (Akyüz 2006). This, together with increased international mobility of capital and labour-market deregulation, has significantly reduced the bargaining power of workers. In almost all industrial countries productivity-adjusted real wages have been falling, resulting in falling shares of labour income in GDP. In DEEs such as China, expansion of exports of manufactures has no doubt brought some benefits to labour, as it moved them from low-productivity rural employment to higher-productivity industries. But in these countries too, industrial wages have fallen well behind the productivity growth.

This means that the purchasing power of labour over the goods and services they are producing has been falling. The consequent threat of global under-consumption and deflation has so far been avoided thanks to surges in spending on consumption and property driven by asset and credit bubbles and increased household debt not only in the US, but also in a number of other AEs and DEEs, notably in Europe. This has also been associated with massive international capital flows and sharp changes in net asset positions of countries.

However, this process has generated not only large global imbalances but also financial fragility and instability, leading to the most serious post-war global crisis. We now face a major dilemma. On the one hand, a return to “business as usual” so as to restore growth based on debt-driven consumption and property booms will simply mean postponing the adjustments needed for reducing trade imbalances and financial fragility, and this will inevitably result in a deeper global economic and financial crisis. On the other hand, financial consolidation and retrenchment by highly indebted consumers and deficit countries to reduce fragility could simply raise the spectre of under-consumption and global deflation, threatening growth and welfare. This trade-off between financial stability and growth exists, however, only in appearance because unless the underlying problem of under-consumption is addressed, neither financial stability nor growth may be sustained for long.

Thus, a post-crisis global economic restructuring is needed. This should include reforms in the sphere of finance so as to reduce the susceptibility of the world economy to recurrent crises and to remove the deflationary bias in the international financial architecture. But it should also seek to tackle global under-consumption by restoring the balance between labour and capital through high wage settlements and a return to full employment policies. Without determined action on these fronts, the coming years may well witness sluggish, erratic and uneven growth, increased instability in asset and currency markets, the rise of economic nationalism, protectionism and trade conflicts, and a strong backlash against globalization.

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**Table 1: Real GDP and Demand**  
(Average annual percentage change) (2004-07)

	Real GDP	Domestic Demand	Consumption	Exports	Contribution of exports to GDP growth (per cent) <sup>c</sup>
China <sup>a</sup>	11.3	9.6	8.2	24.1	34.1
Germany <sup>b</sup>	1.9	0.8	0.4	9.6	92.5
Japan <sup>b</sup>	2.3	1.5	1.3	9.8	49.9

Source:

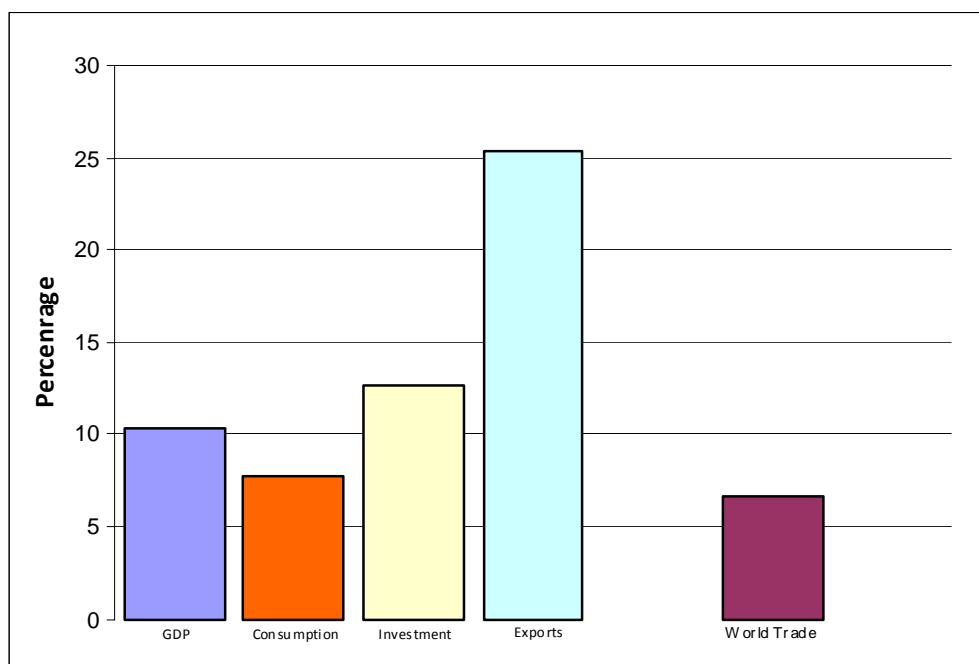
a: Akyüz (2010)

b: IMF: WEO Database.

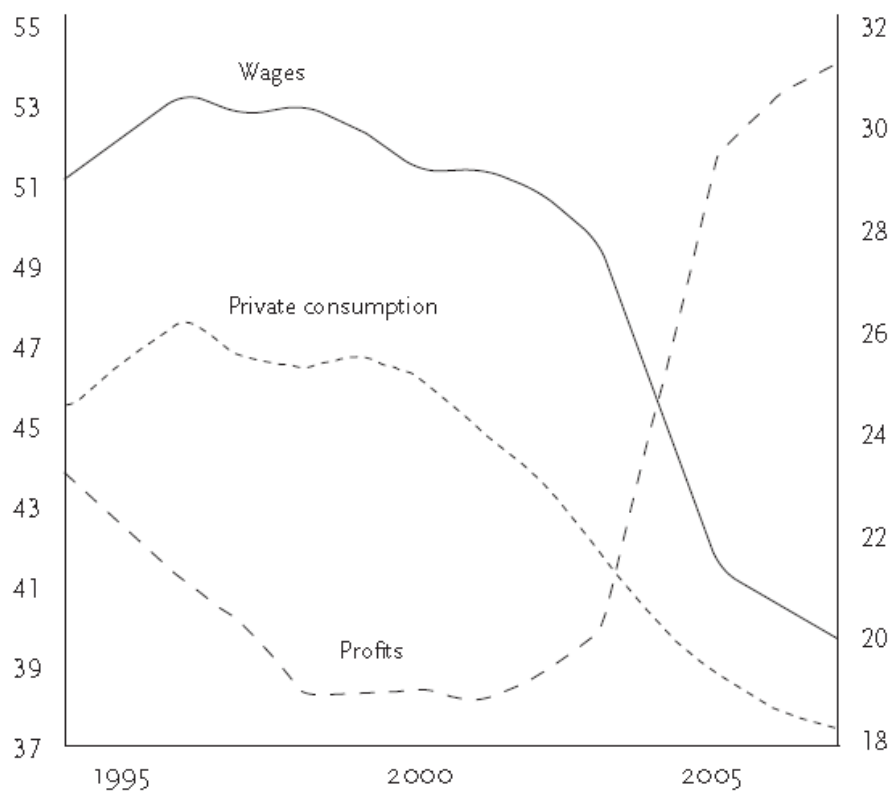
c: Estimates for China and Japan are based on the methodology described in Akyüz (2010), using import contents data from Johnson and Noguera (2009) for Japan. Estimates for Germany are from Kranendonk and Verbruggen (2008)

FIGURES

*Figure 1: China – Real Growth Rates (2002-08)*

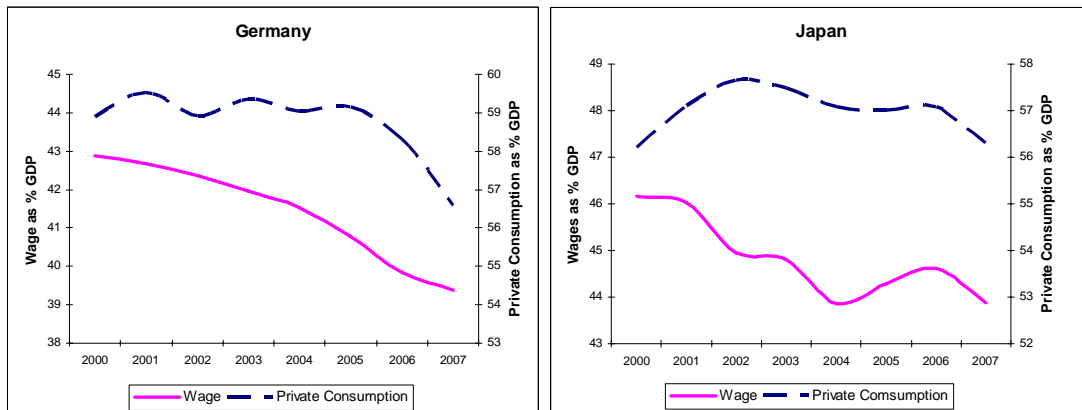


*Figure 2: Wages, profits and private consumption in China (As a percentage of GDP)*



Source: Ho-Fung (2009)  
 Profits right scale; wages and consumption left scale.

**Figure 3: Wages and private consumption in Germany and Japan**



Source: OECD Economic Outlook and IMF IFS databases.



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