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China-USA: The uncertain aftermath of the crisis

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It is now time to pose the question of what comes after the crisis. Not because it is ending, as we are led to believe by the on-message optimists whose sole concern is that everything goes back to what it was before, but because it is useful to identify the obstacles which a possible recovery will come up against. This question concerns the world economy as a whole but it is dominated by the fate of the China-USA duo which some call Chinamerica, or indeed Chimerica.

On the immediate future there is a broad consensus on this point at least: 2009 will be one of the worst years the world economy has known. 2010 could see an exit from recession, or in other words a return to weak growth. But even in this relatively optimistic scenario, the question remains open of what might happen then. A return to the previous situation seems ruled out for several reasons.

First one does not emerge from a crisis in the same state as one entered it. In the first place, the stupendous accumulation of bad debts, interconnected in every sense, will not have been purged in two years. We might here lay down a kind of theorem: the time necessary to rehabilitate finance will be inversely proportional to the degree of nationalisation (the new n-word) of the banks and financial institutions concerned. It is moreover striking to note that even The Economist has come out in favour of nationalisations[1].

The OECD devotes a good part of its recent report on economic perspectives[2] to comparing the experiences of Sweden and Japan, confronted at the beginning of the 1990s to a crisis similar to that which has just struck the whole world. Sweden nationalised (to re-privatise after purging) whereas Japan dallied. In the first case, the crisis was of limited length; in the second, it was strung out over at least a decade. The logic of the measures taken until now has contributed to making a Japanese-style scenario probable.

The recovery and safeguard plans will then lead to huge budget deficits. The OECD envisages for 2010 a deficit of 7% of GDP for the whole of the euro zone and 11.9% for the USA. At the same time, job destruction will lead to a step change in the unemployment rate. Again according to the OECD, it will go from 7.5 to 11.7% in the euro zone and from 5.8 to 10.3% in the USA between 2008 and 2010. The question of a return to growth after 2010 will then be posed in a context marked by contradictory objectives: improving competitiveness while creating jobs, and reviving demand while carrying out new cuts in social budgets so as to reduce deficits. Of course, these are projects of bourgeoisies concerned to restore capitalist logic in general and their

[1] "In knots over nationalisation", *The Economist*, February 26, 2009, http://gesd.free.fr/inknots.pdf

[2] *OECD Economic Outlook*, Interim Report March 2009, http://tinyurl.com/oecdint9

sources of income in particular. It is necessary to advance very different proposals challenging this logic of competitive growth which turns its back on the satisfaction of social needs and the adequate treatment of climate change.

But it would be completely wrong to think that capitalism is capable of self reform other than under the pressure of the social movements. The OECD report cited above moreover sends a chill down the spine because it unambiguously expresses the will of the dominant classes that everything goes back as it was before, since the measures implemented to deal with the crisis could have harmful consequences; it stresses the necessity of rectifying the public deficits, which implies new cuts in social budgets.

Can the US model function as before?

With a little hindsight, we can better measure how prophetic in relation to the US model were the analyses of lucid economists like Wynne Godley, who pointed out ten years ago the list of seven non-sustainable processes[3]. The US model[4] can be summed up in the following manner: internal demand tends to be structurally higher than national production and this disequilibrium essentially stems from household consumption which increases more quickly than household income. At the time of the crisis, the savings rate of households was virtually zero, which effectively means that they were consuming 100% of their incomes. Three factors had rendered this headlong rush possible:

- the financial illusion: the swelling of household income through shares or property gave them the illusion of a lasting wealth. They no longer consume according to their current income but the growth of the (virtual) value of their assets: this is the wealth effect.

- generalised over-indebtedness: consumption was boosted by a recourse to indebtedness which has affected every category of household. It is the poorest 20% of households which have most increased their indebtedness (by 90% between 2000 and 2007): this was the weak link of the system, the natural public for the subprimes. But in mass of credit, the richest 20% of households contributed in themselves half of the progress registered between 2000 and 2007[5].

- credit growth: this overconsumption has led to a growing trade deficit which has been covered by an inflow of capital originating from the rest of the world.

Can the US rediscover the same rhythm of growth it had before the crisis? That seems unlikely, notably because of the behaviour of households. Their savings rate will increase and has already begun to do so once their net wealth begins to fall, rendering necessary a fall in indebtedness (figure 1). The study by the McKinsey Institute mentioned above estimates at 27 points the gap between the rate of household indebtedness and its historic trend (figure 2). To lower this ratio by 5 points, it would be necessary to increase the household saving rate from 2.3 to 5%. But this could lead to a loss of hundreds of billions of dollars in consumption in the years to come.

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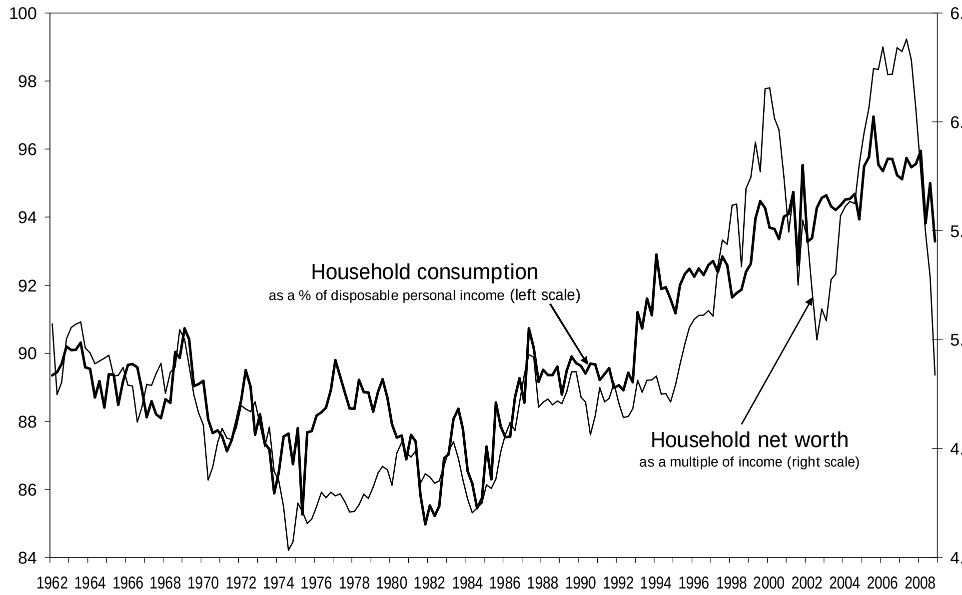
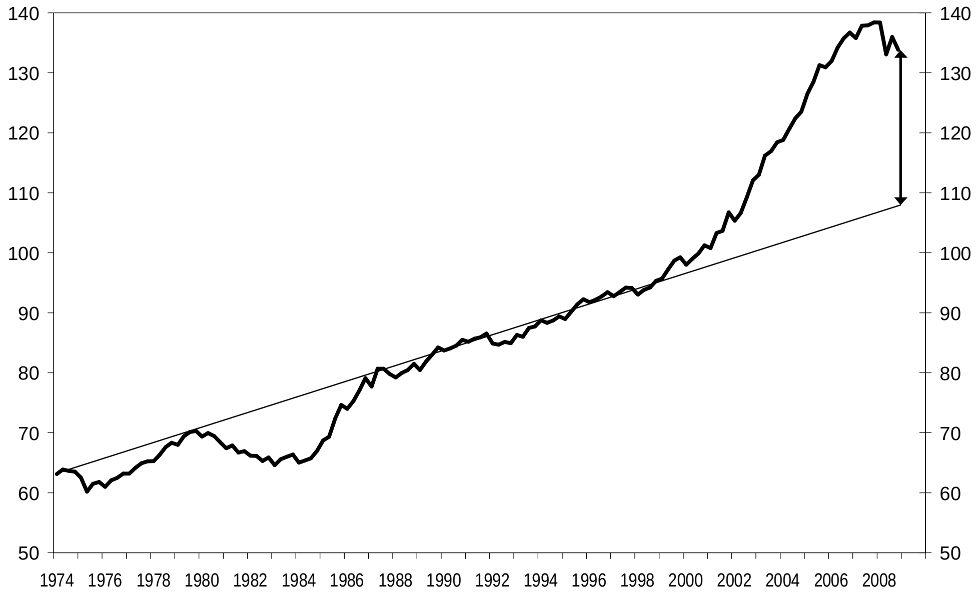
[3] Wynne Godley, “Seven Unsustainable Processes”, The Levy Economics Institute, 1999, http://gesd.free.fr/godley99.pdf
[4] Michel Husson, “Etats-Unis: la fin d’un modèle”, *La Brèche* n°3, 2008, http://hussonet.free.fr/usbrech3.pdf
[5] McKinsey Global Institute, “Will US consumer debt reduction cripple the recovery?” March 2009, http://gesd.free.fr/cripplec.pdf

Figure 1
Household consumption and net worth



Sources : Federal Reserve Flow of Funds, Bureau of Economic Analysis

Figure 2
Household indebtedness



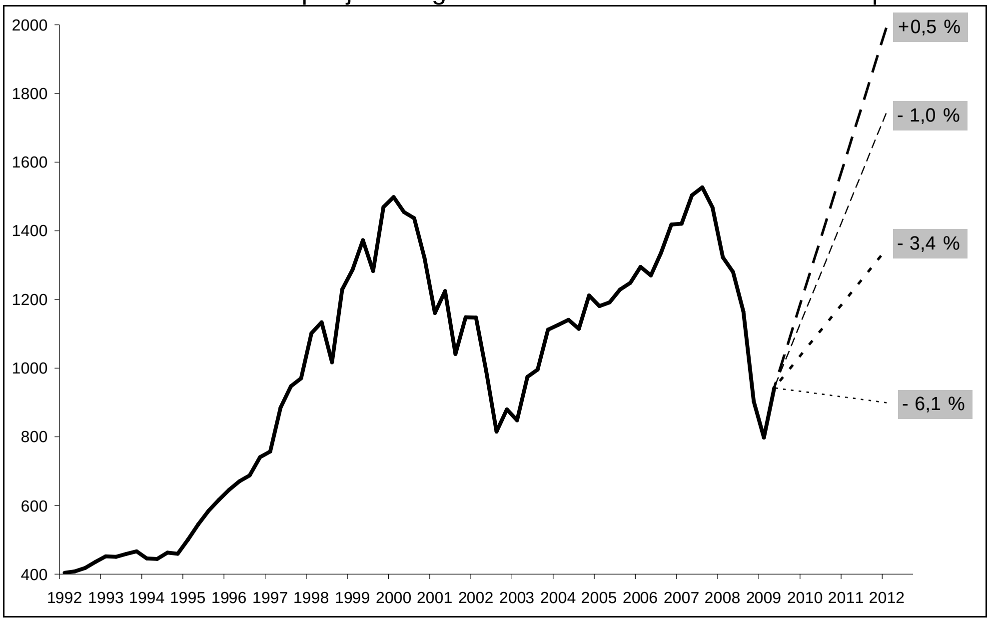
as a% of disposable personal income. Sources : Federal Reserve Flow of Funds, BEA

Another approach[6] relates the evolution of the consumption of households to the valorisation of their assets, measured by the S&P500 stock market index. The message is the following: in order for consumption to be maintained, it is necessary that stock market prices return to, indeed exceed, their pre-crisis level. In short, a new stock exchange boom is needed. If, on the other hand, share prices stabilise at a level equivalent to the average of the last 10 years, consumption falls by 3% and by 6% if prices return to their pre-Internet boom level (figure 3).

[6] Olivier Passet, “Quel impact de la crise sur la croissance à moyen terme?”, *Note de veille* du CAS n°113, October 2008, http://gesd.free.fr/eveil113.pdf

Figure 3

S&P 500 index and projected growth rate of household consumption



Sources : Standard & Poor's, Passet (2008)

The trade deficit is tending to shrink, but we are entering a period of lastingly reduced growth. Such a slowdown will be hard to sustain taking account of the degree of social inequality. Here we touch on one of the most astonishing features of the US model, which is the extraordinarily unequal distribution of the "fruits of growth". Between 1992 and 2006, the average income per household after tax increased by 2.1% per year before inflation. But the increase was only 1.1% for the poorest 20% of households against 2.9% for the richest 20%[7]. In other words, two thirds of the increased income provided by growth was appropriated by the richest 20%, one third of this by the richest 1%! If we add to this note the formation of an enormous public deficit, the conclusion is that the main condition for a return to a more balanced growth in the US is a flattening out of inequality through a radical tax reform and a better distribution of incomes. Faced with such a perspective a very powerful opposition bloc emerges made up of the beneficiaries of the model and the major part of the industrial apparatus which has found in unbalanced globalisation an essential source of profits, not to speak of finance in all its forms. In the short term, from their viewpoint, what matters is to deflect the cost of the crisis on the taxpayers, at a constant tax structure. In the medium term, the obstacle resides in the enormous gap between the economic conditions of another model and the current relationship of forces.

Can China continue to finance the US?

Before the crisis, one could argue that the USA-China duo, considered as a whole, had acquired a relative coherence. To simplify, China sold to the US, accumulated dollars then invested them in Treasury bonds so as to finance the US trade deficit. This schema allowed sustained growth in the two countries, and each could benefit, all the more in that a good part of Chinese exports are the result of US investments in China and that low price imports allowed downwards pressure on the value of labour power in the United States.

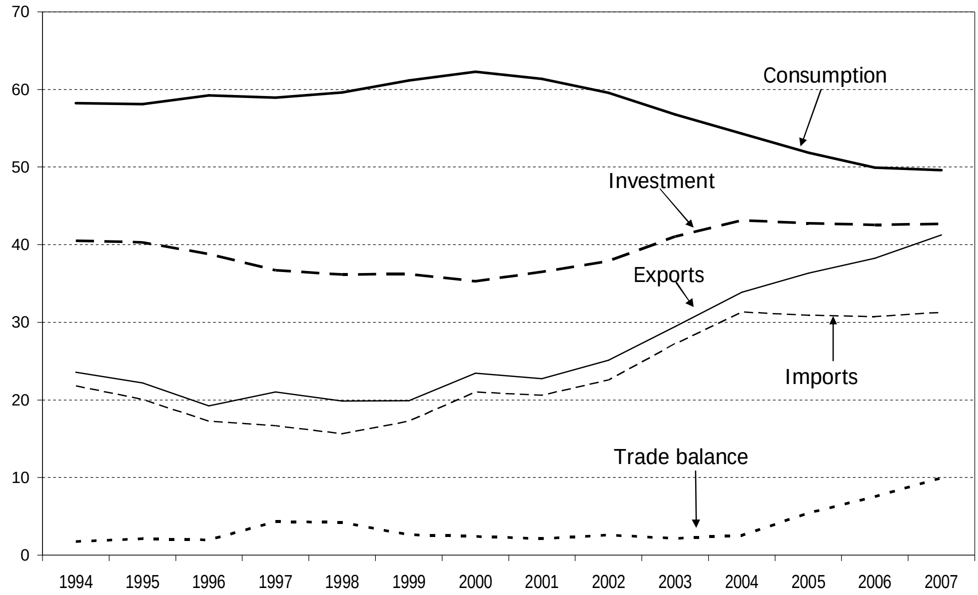
[7] Source: Congressional Budget Office, Data on the Distribution of Federal Taxes and Household Income, April 2009, http://tinyurl.com/cboquinti

The crisis represents a considerable shock for this model and poses the question of its possible renewal. The main question is whether China and in general the emergent and/or oil producing countries will indefinitely agree to finance the US deficit. China has already accumulated 1,700 billion assets denominated in dollars, which makes it in fact the US's main creditor[8].

The "optimists" stress that China has an interest in continuing to finance the US, lest the dollar fall, with the consequential devaluation of the assets denominated in dollars that it holds. According to the director general of the commission of Chinese banking regulation, this is indeed "the only option"[9]. But what are the limits of this process? The huge US budget deficits would indeed necessitate a growing recourse to external financing. According to some estimates, the net US foreign debt could be multiplied by 3 and reach 10,000 billion dollars in 2015, the gross foreign debt going up to 23,000 billion dollars[10]. It would then be necessary that the Central Banks collaborate in the reconstruction of the United States. On the other hand, the reabsorbing of the US trade deficit would have the advantage of reducing global imbalances and thus the excess of global liquidity which is one of the sources of the current crisis.

But we have seen that this involves a radical change in the distribution of income and/or a lasting slowing up of growth in the US, and thus a reduction in Chinese exports. The question of the dollar thus appears central. To restore its trade balance, the US has to bring the dollar down, but this fall renders all the more difficult the inflow of capital. It could be attracted by higher interest rates but at the risk of slowing down growth and increasing the weight of the debt.

Figure 4
The structure of demand in China



Source : United Nations, http://tinyurl.com/uncnat

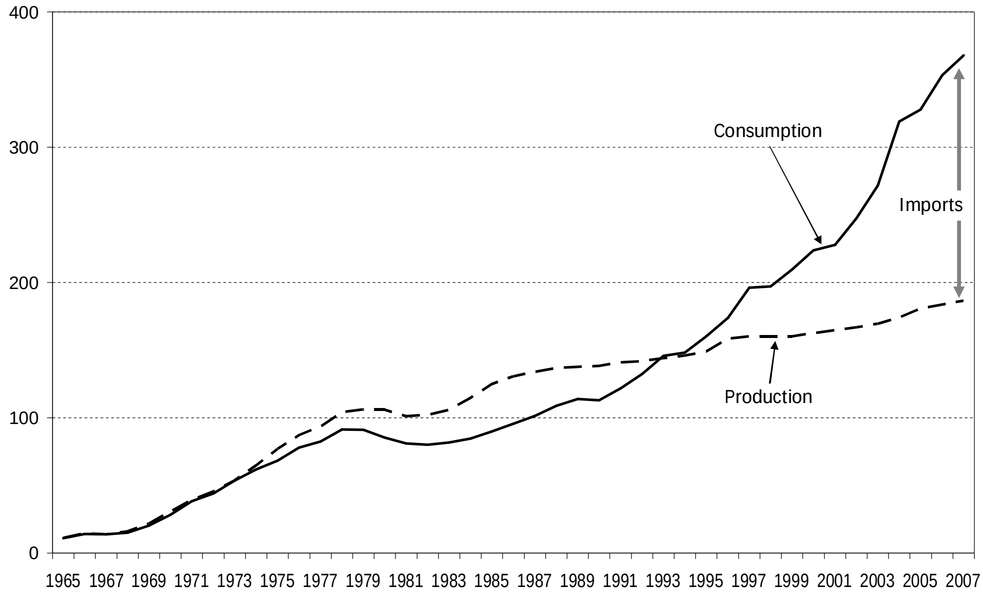
The other big argument of the tenants of the "as you were" positions is that growth can only be drawn by exports and that China will continue to finance US deficits to ensure expanding market openings. But that can only go on for some time because the

[8] *Financial Times*, February 22, 2009
[9] *Financial Times*, February 12, 2009
[10] Patrick Artus et Marie-Pierre Ripert, "Dette extérieure des Etats-Unis : 23 000 milliards de dollars en 2015 ?", *Flash Natixis* 219, Mai 2009, http://gesd.free.fr/flas9219.pdf

Chinese mode of growth is not sustainable. On the economic level, the structure of demand is aberrant (figure 4). With an excessive weight of exports (41.3% of GDP in 2007) and investment (42.7%) and a decreasing share of private and public consumption in the market outlets (49.6% of GDP in 2007) it is then exposed to risks of over-accumulation and, symmetrically, of under-consumption

The trade surplus has played a motor role in recent years, but it is menaced by the lower growth of market openings and, in the long run, by growing energy dependence (figure 5). One can even predict an energy crisis in China from 2020 which will restrain its growth[11]. For now on, China needs to refocus on the internal market under the pressure of the social tensions relating to jobs, health and pensions. These social and energy preoccupations are moreover very much present in the recovery measures taken by the Chinese government. However, somewhat as in the US this reconversion of the growth model comes up against the challenging of social inequality that it implies.

Figure 5
Oil production and consumption in China - 1965-2007



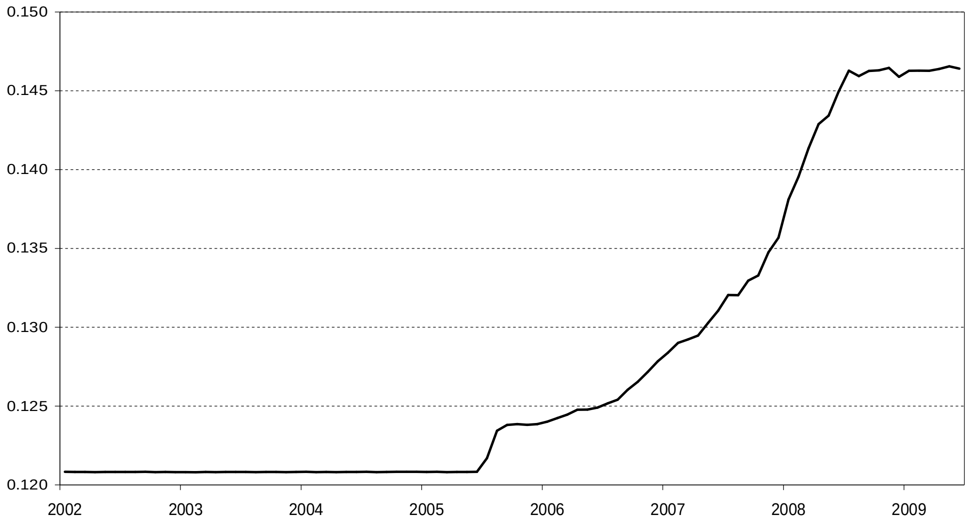
Millions of tons
Source : BP Statistical Review of World Energy 2008, http://tinyurl.com/bpstat8

In both countries, another often neglected factor must be added, which is the relative irreversibility of the international division of labour. The US simply no longer produces a part of the goods that it imports and neither can the Chinese productive apparatus be easily reconverted towards the satisfaction of internal demand because of the rigidity of the productive structures and also the very unequal income distribution.

The main stumbling block immediately is the exchange rate of the yuan. The Chinese currency (yuan or renminbi) is undervalued and the US has for several years pressured the Chinese in favour of a revaluation of its currency, moreover indexed against the dollar. This is what was done between July 2005 and July 2008: the yuan then regularly appreciated in relation to the dollar, by 21% over these three years. Since then, the Chinese authorities have again maintained a fixed exchange rate in relation to the dollar (figure 6).

[11] Minqi Li "Peak Energy and the Limits to China's Economic Growth", University of Massachusetts Amherst, 2008, http://tinyurl.com/minqili8

Figure 6
Exchange rate yuan/dollar



Source : University of British Columbia, http://fx.sauder.ubc.ca/data.html

This configuration is not however definitive and the Chinese government has just taken two initiatives aimed at a reshaping of the international monetary system. The first is the proposal, put forward at the time of the last G20, of replacing the dollar by an international currency based on an extension of IMF special drawing rights. This proposal was supported by Russia, Brazil and Argentina. The second was the signature, from December 2008, of currency exchange agreements with several countries (Malaysia, South Korea, Hong Kong, Belarus, Indonesia and recently Argentina) for a total value of 95 billion dollars[12]. These measures show that China is seeking an exit from its face to face with the US by establishing non dollar relations with other trading partners.

Conclusion: a capitalism without alternative

The imbalances of the world economy are, with the universal decline in wages, one of the essential causes of the crisis. To emerge from it, a complete remodelling of the world economy would be necessary, ensuring a refocusing of the economies on the satisfaction of majority domestic needs. It would allow the deflation and rationalisation of trade exchanges. Such a reorientation is then a necessary – but probably not sufficient – condition of a correct management of the environmental challenges.

However, the transition from the current chaotic configuration to this new balanced configuration comes up against two types of obstacle. The first is social and results from the resistance of the dominant social interests whose project is to return to business as usual which suits them perfectly. The second is at the economic level: the relative rigidity of the international division of labour installed by globalisation renders the transition, which could not be immediate, uncertain. In these conditions, the tensions between the will to maintain the existing order and the need for a profound reorganisation at the economic, social and environmental levels open a long period of instability and uncertainty. In essence, capitalism has no alternative - acceptable in its eyes – to the arrangements which led to the crisis, in such a way that the real exit from crisis passes through an alternative to capitalism.

[12] "China strikes currency swap deal with Argentina", *China Economic Review*, 31 March 2009, http://tinyurl.com/yuanswap