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The Great Rebalancing: Trade, Conflict and the Perilous Road Ahead for the World Economy

Michael Pettis

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In the Great Rebalancing, Michael Pettis (2013) argues that existing global trade and capital imbalances must eventually balance out. The fundamental process generating economic crises, according to Pettis, is not the "animal spirits" described by Keynes but excessive deficits and surpluses of trade and current accounts. Large-scale economic imbalances, such as the trade deficit between China and the United States and European Union debt issue, can only be resolved with either policy-induced changes in trade flows between nations or, should there be lack of political willpower for change, painful systemic shocks to the global economy. Specifically, he predicts that little possibility remains for governments to resolve existing, widening imbalances before a severe, worldwide economic downturn - the world will almost inevitably undergo a "great rebalancing" that will cause a euro zone breakup and a "lost decade" for China.

Most of the book focuses on analyzing macroeconomic accounting identities of nations and their impact on global trade and capital flows. Pettis suggests that trade and capital account imbalances are not a moral or historical issue, but one caused by importers and exporters responding to incentives created by distortionary interest and exchange rates. Pettis develops the relationship between trade and capital flows in detail, arguing that nations involved in large trade imbalances such as China, Germany and the United States are fragile and running unsustainable models of growth. However, I believe that many of his conclusions are based on specific, potentially problematic assumptions, and are therefore neither as straightforward nor as inevitable as he claims.

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Pettis states that currency manipulation is essentially another form of trade intervention, arguing that currency depreciation will decrease imports and increase exports. This is the situation described in traditional economic literature, but a variety of mechanisms must also be considered. For example, if the nation has a progressive nominal tax structure, a currency appreciation will effectively lower real taxes. The positive impact on purchasing power potentially offsets the negative impact of the currency appreciation. This mechanism softens the impact of an appreciation, and could conceivably even reverse it.

The real impact of a depreciation or appreciation, however, is largely determined by overall wage flexibility in the economy. If wages are perfectly flexible and the economy at full employment, an appreciation will not cause any relative price change in the economy – real wages will adjust to original levels; there are no benefits or costs associated with the lower exchange rate. On the other hand, if wages are inflexible downwards, the export sector cannot compensate for the negative impact on competitiveness of an appreciation by lowering wages. Take China as an example: a higher value of the renminbi will indeed cause an increase in imports, but firms in export-oriented industries would, should the state decide not to offer subsidies, be forced to downsize to return to profitability. Under such a scenario, an appreciation may not be desirable as it may cause unemployment in export-oriented sectors of the economy.

This is precisely what Milton Friedman (1992) described to have happened in China after the United States artificially raised the price of silver. The high Chinese Silver Dollar value of the 1930s caused severe unemployment and social chaos, eventually contributing towards the 1949 Communist revolution. The expensive silver's negative influence on the Republic of China's economy highlights the potential pitfalls of an currency appreciation, and should be considered as a caution for advocates of appreciating the renminbi.

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Pettis argues that in China "labor may be cheap, but capital is free", claiming that exporters in China have access to near-costless capital provided by excessively high, policy-induced domestic savings rates. With more loan supply than demand, banks lend at near-zero rates. Pettis argues that this process causes China's economic growth to be too capital-intensive. Labour is underutilized, wages too low, and the economy suffers from a lack of domestic consumption.

But is labour in China really "cheap"? Manufacturing-oriented firms seem to be struggling to find workers, a possible sign of menial labour shortage (Chu, 2013) On the one hand, the "fresh" supply of labour from rural areas dwindles as foreign investment and state-subsidized development reaches further inland. On the other, while major cities experience a surplus of college graduates from the decade-long higher education boom, they often choose to exclude themselves from labour markets. Blue-collar work is stigmatized in China - people with college or vocational degrees will often be pressured by family members to find office jobs and, when they cannot land employment in their field of study, live off parents or become extremely underpaid clerks in cities (Jou, 2013).

Also, macroeconomic theory suggests that the relationship between the price of capital and wages is not as simple as Pettis claims. Assuming that the substitutability of capital and labour is perfect, rental rates and wages are not related at all in a single good economy. That is, if a widget can be produced with either a machine-day or worker-day, for example, in a competitive economy the real wage will be one widget per day regardless of the price of capital. Under a high labour/capital substitutability scenario, unless other factors of production are involved, it is unclear how subsidizing capital stock growth or capital price will be detrimental to workers.

Under complimentary capital and labour, low capital costs will drive labour compensation up by increasing labour's marginal productivity. Even if the substitutability of capital and labour is close to perfect, cheap capital must be fundaddressing the labour-capital mismatch if there is a capital shortage.

The relationship between wages and capital supply is therefore not nearly as clear-cut as Pettis suggests. If there is real demand-supply mismatch in China's labour markets, the Chinese government should address the issue by methods such as subsidizing technical training instead of simply constraining capital supply. Trade theory models do not readily support his claim that cheap capital can lower wages except under peculiar circumstances, and even then subsidizing capital may have positive effects for the economy such as addressing a capital-labour mismatch in the intuitive sense of “giving tools to workers”.

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Pettis proposes that through a currency appreciation by the Central Bank [of China], "nearly everyone else in China is a winner". By revaluing the renminbi, imported goods and services become cheaper and the relative wealth of almost all Chinese citizens will increase. "Every household and nearly every business in China is...an importer, so unless they own a lot of assets abroad they are effectively short on dollars, and will benefit from an appreciation in the renminbi".

A renminbi appreciation, however, benefits individuals disproportionately, potentially deepening China's existing social inequalities. Pettis is no doubt right in saying that every person in China is to some extent an importer. Averaging consumption patterns across individuals, however, overlooks the fact that some Chinese individuals consume substantially greater amounts of imported goods (and services) than others. People who are most likely to import are those with high income. On the other hand, blue-collar, low-income workers are unlikely to directly consume many or any foreign goods at all; even if the wealth effect of an appreciation reaches them, the benefits are most likely marginal.

It is therefore a real possibility that a renminbi appreciation will worsen income inequality in China, potentially causing social and political instability - even if there are no negative effects on employment or wage levels, the wealth effect of an appreciation is unequally distributed across the population. The aggregate consumer gains, but the benefits are heavily slanted towards those with higher income.

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Pettis argues that the European Union debt situation is partly the result of Germany pursuing export-oriented growth policies at the cost of other European nations. The only way for the euro zone to rebalance in the long run is for Germany to move towards consumption-driven growth and reduce its trade surplus. Without actions from the supply side of the imbalance, unilateral efforts of trade deficit countries such as Greece and Spain are useless. Pettis lays out a grim future for nations like Greece with deficits and fixed exchange rates - "[they must] either accept high employment for many years or intervene in trade, most easily by abandoning the euro."

However, there are powerful automatic adjustment mechanisms available to correct trade imbalances that Pettis does not include in his discussion. For example, making the reasonable assumption that the amount people consume depends positively on their affluence, individual wealth can serve as an adjustment mechanism for trade deficits (Scitovsky, 1969). When a country runs a prolonged trade deficit, real wealth of its citizens falls. Given that wages are downwards flexible, consumption will decrease to full employment production. With such a mechanism in place, the deficit problem would solve itself.

Another example of automatic adjustment is the interest rate's role in shifting the consumption-production balance. In a single good, flexible wage, two-nation world economy, each nation will produce more than it consumes when the interest rate is high and consume more when it is low. A production surplus will then cause a nation to loan out goods in exchange for future consumption. With an increase in the supply of current goods for loan, the interest rate drops as the nation tries to clear its stock and vice versa. In an ideal world, the interest rate will therefore fall until all goods produced today at full employment are immediately consumed. As long as interest rates are allowed to float, both nations can achieve full employment regardless of the trade situation.

These mechanisms apply to the euro-zone situation. Greece does not in fact need to completely rely on the exchange rate to adjust con- the regaining of exchange rate flexibility by leaving the euro.

In conclusion, Pettis correctly identifies the connection between trade flows and the demand and supply of labour and capital markets. His analysis in the Great Rebalancing is however not sufficiently rooted in theory to fully explore the system he lays out. He excludes important insights from international trade and macroeconomic theory.

Wage flexibility is no doubt crucial for the balancing of an economy. Without downward flexibility of wages, countries running a trade deficit such as the United States will suffer unemployment if they try to use fiscal tightness to reduce the deficit. The same may also be true for trade surplus countries such as China, where a currency appreciation under inflexible wages will cause unemployment in export-oriented sectors. As Max Corden (1986) puts it, "to make devaluation necessary money-wages have to be inflexible and to make it effective real wages have to be flexible".

Pettis completely overlooks the importance of wage flexibility in his argument on trade deficit countries. No matter how much Germany shifts its model of growth, countries such as Spain and Greece will not be able to regain competi-