

Global or Local Imbalance?

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A lot is being written about the trade imbalance between the US and China. And with pressures being built on China to appreciate Yuan, it is only going to worsen the situation through retaliation etc.. We would attempt to raise two issues in this regard. First, we need to place this issue in the backdrop of the *local* imbalances in the form of declining wage share in *both* the countries. With declining wage share, the possibilities of mass consumption decline in importance. We believe that the growth trajectory in that case *perforce* becomes dependent either on exports to the rest of the world (China) or on consumption of the rich through speculative gains (the US). We argue that both these growth trajectories could be unstable in the long run.

Second, we would like to stress certain similarities between the growth path of China of today and Japan of the early 1980s. Dependence on external markets for growth, declining wage share, growth as the manufacturing base of the world etc. are some of the striking similarities between the two countries during their respective phases of export-led growth. Could one derive some lesson from the Japanese experience of that time?

Global Imbalance in trade is not as much of a problem for China as it is for the US, especially since it is at the receiving end. With growing fiscal deficit and declining personal savings through the 2000s, the US has become the biggest debtor to the rest of the world. And, then came the economic crisis which has worsened the problem for the US manifold. In this backdrop, the US follows the classic arm-flexing tactics where China is being asked to appreciate its currency. It is quite reminiscent of the Plaza Accord where the Japanese and the Germans were forced to appreciate their currency to reduce the trade deficit that the US was running vis-à-vis them.

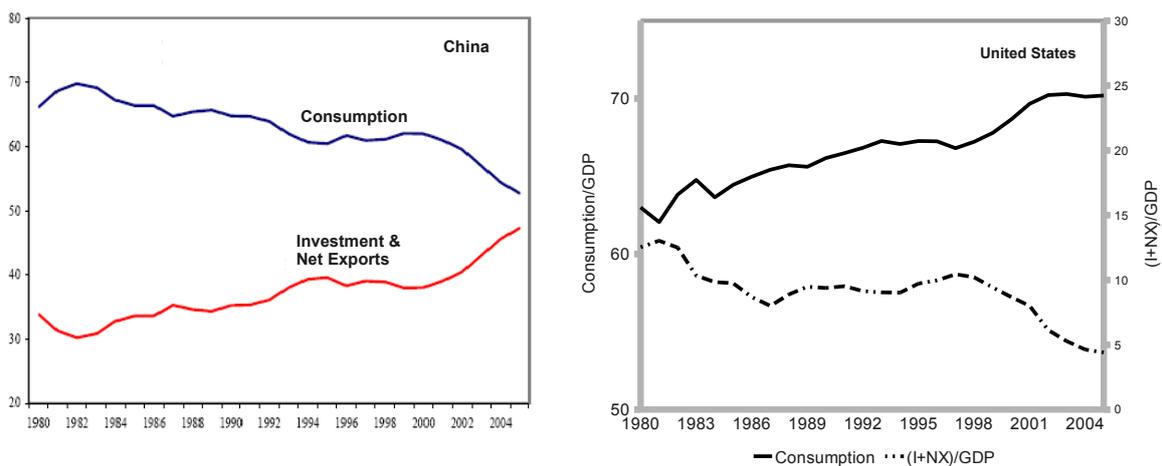
This concept note is divided in two sections. Section 1 discusses the instability inherent in growth trajectories being followed in both China and the US at present. Section 2 presents the Japanese growth story from late 1970s to mid-1980s which could throw some light on the present growth path of China.

1 The Local Imbalances and Instability

There seems to be a striking similarity across countries, with very few exceptions, in terms of the growth of income and wealth inequality since the late 1970s. Piketty and Saez (2003) have done an extensive study of the change in the income share of the top income groups in different advanced countries. They find that the US, Canada, the UK have been witnessing a drastic increase in the share of top decile in total income since 1980. There have been similar studies on India (Banerjee and Piketty (2005)) and China (Piketty and Qian (2009)) arriving at the same conclusion. Since our focus is on the US and China, we would concentrate in the next subsection on their *local* imbalances.

1.1 Imbalances in the US and China

In many ways, the growth trajectories of the US and China since the 1990s seem to work in exactly the opposite direction. Let us present some stylised facts here. First, despite an increase in income inequality in both the countries, consumption as a share of GDP has increased in the US and decreased in China. Second, while there is a dramatic increase in investment in China, it has declined in importance in the US. Third, there is a growth in trade surplus of the Chinese even as the US registered an ever increasing deficit (fig. 1).



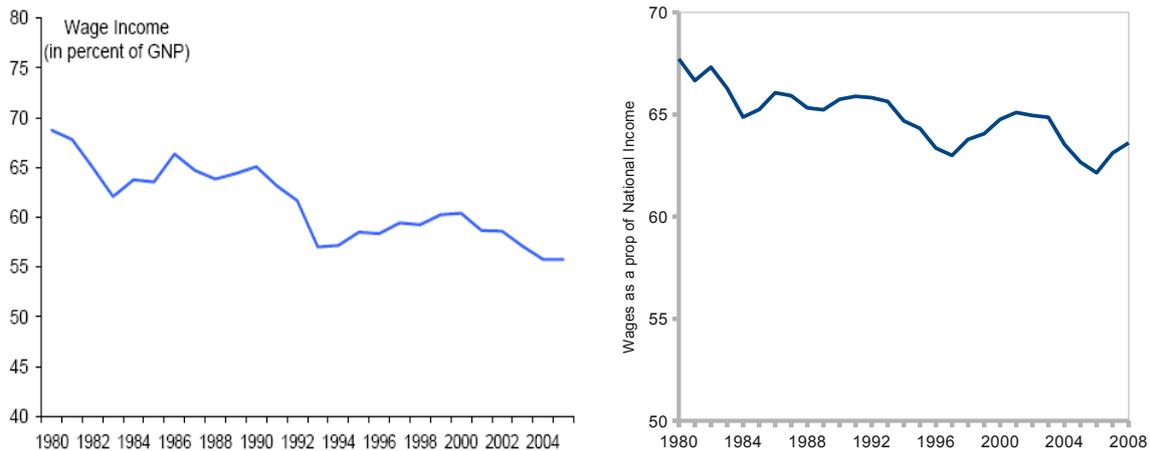
Note: Data of Investment for the US includes only the non-residential investment.
Source: Figure for China taken from Aziz and Cui (2007) and author's calculation for the US data taken from the BEA

Figure 1: Consumption and sum of Investment and Net exports as a proportion of GDP

One similarity that exists, however, is the steady decline in the share of wages in both these countries (fig. 2).

1.2 Whatever happened to underconsumptionist stagnation?

We believe that these developments have serious implications for the long run growth trajectories of these two countries. Let us evaluate the various sources of growth from



Note: Wages for the US indicate compensation for employees.
 Source: Figure for China taken from Aziz and Cui (2007) and author's calculation for the US data taken from the BEA

Figure 2: Wages as a proportion of GDP

the perspective of demand. There are five sources of aggregate demand that can have a positive impact on the overall rate of growth viz.: workers' consumption, capitalists' consumption, investment, government expenditure and net exports. Let us evaluate them one by one.

1. Workers' Consumption: A decline in share of wages in GDP would obviously lead to a decline in their consumption share. This is what the underconsumptionist argument would tell us.
2. Capitalists' Consumption: Even though the profit share is increasing, increase in consumption of the capitalists (out of their current income) would not offset the decline in workers' consumption because the capitalists have a lower propensity to consume than the workers.
3. Real Investment: This could decline as a result of rapid financialisation. Suppose the firms invest in two kinds of assets—financial and real assets. In that case, the respective rates of return net of risks should be equal for these two assets. Otherwise the firms could keep investing in the asset which fetches a higher rate of return till such point at which they both get equalised. In the event of an increase in the rate of return on financial assets due to booming stock markets, the desired rate of profit on real investment increases. This could lead to underinvestment because all those projects which fetch a lower rate of profit than a higher rate of return on financial assets would not be undertaken any more.
4. Government Expenditure: There is always a downward pressure on the fiscal expenditure in the era of neoliberalism in the name of market distortions. What is even more interesting is that despite being opposed to active state intervention in

driving the economy, there is a striking consensus amongst the capitalist class vis-à-vis military expenditure, which is in complete contrast to what Keynes-Kalecki would have imagined and argued for. A case in point is the extent of opposition in the US Congress to minimal health care reforms even as there was strong approval for President Obama's plan to send more troops to Afghanistan.

Given that these sources of demand decline in importance in the era of neoliberalism, there are only two ways left through which growth can be pumped up. First, external markets would be explored to increase the component of net exports. This is precisely what China has been doing since the 1990s. Whether this process is stable or not, we would examine in a moment. Thus, we find that despite a decline in the share of consumption, China is riding on the tide of growing trade surplus.

Second, there can be an independent (of the current income stream) stimulus to pump up consumption of either the capitalists or the workers or both. This is the route that the US has taken, especially since the mid 1990s. Therefore, despite growing trade deficit and declining non-residential investment (and even a budget surplus in the late 1990s), the US saw a significant growth in the late 1990s and the present decade prior to the crisis.

1.3 Inherent instability with capitalists' consumption-led and export-led growth

We would argue that both these trajectories are ridden with inherent instability. While the US is witnessing one of the worst instabilities in a long time, it does not seem so clear for China. Let us analyse these growth paths separately and see how they have and could pan out in the future.

1.3.1 Capitalists' consumption-led growth

We just saw that one of the routes left for the growth rate to pick up is through an increase in consumption of the rich which could take place through capital gains in the asset price markets i.e. the wealth effect. This, in turn, makes the growth process vulnerable to the vagaries of these markets. It would require speculative bubbles of one kind or another to sustain the surge in the consumption demand, which should constantly be at a level sufficient to counter the underconsumption effect. The growth story of the US since the mid-1990s is a testimony to this. The growth rate in the US economy in the 1990s was primarily sustained by the increased consumption fed by the stock market boom, which was riding on the DotCom bubble. As soon as this bubble went bust in 2000, the economy was in need of another speculative bubble to sustain itself. This was provided to it in the form of the housing market. With the collapse of the housing market and the absence of another speculative bubble, the US economy finds it difficult to tide over the present crisis.

We believe that though there is some reversal in the economic activity in the US, it is too early to say that the crisis is over. The basic paradox that the US economy faces

today is that the very forces which averted an underconsumptionist stagnation since the 1990s are steadily declining. Not only has the residential market plummeted seriously, there has been a decline in the share of consumption too. While it is obvious that the residential investment was expected to decline, it is the second factor that has a long term potential of aggravating the problems for the US economy.

A few words are in order on the declining consumption, especially of the capitalists driven by the wealth effect. First, since the increasing asset market prices, both the stock and the housing markets, were the result of increasing speculation of wealth owners as well as financial corporations, any crisis in these markets would eliminate the wealth effect sooner than later, which is what seems to have happened (consumption share in GDP has either declined or stagnated in most of the quarters since 2007). Second, the consumption against increased nominal wealth had to be financed by debt, which is a self-limiting phenomenon over time. Precisely for these two reasons, it is unlikely that the share of consumption could go up in this phase of recovery. On the one hand, the source of the wealth effect has disappeared. On the other, the household would have to repay the accumulated debt back to avoid bankruptcy. Both of which would have a dampening effect on household consumption (see fig. 3). This should be seen together with the the suppressed underconsumptionist tendency which would add to the decline in capitalists' consumption.

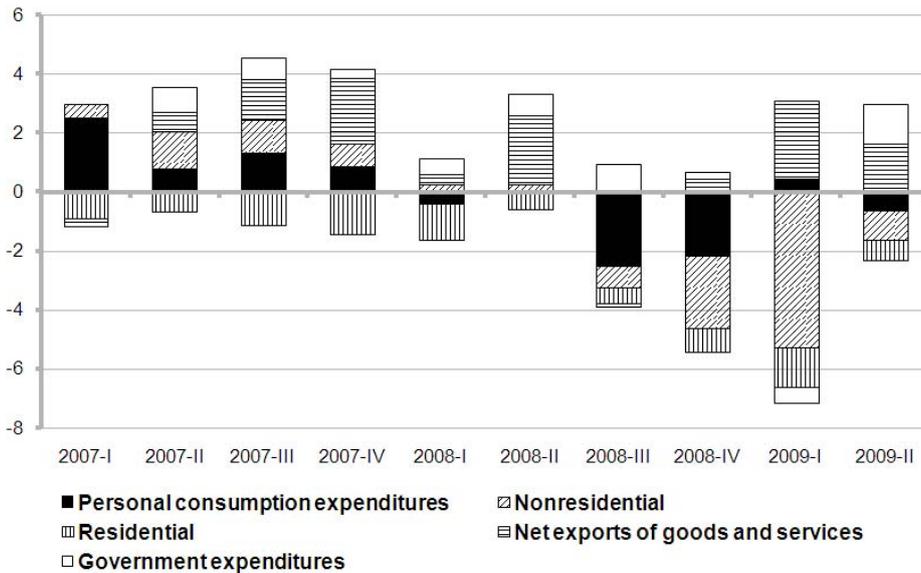


Figure 3: What is driving the US recovery?

A declining share of consumption with declining investment means a decline in the income multiplier along with a decline in the base of growth itself. If consumption in the US remains dormant or worse still decreases, it would be a bad news for China as well.

1.3.2 Export-led growth

Unlike the consumption-led growth of the kind discussed above, the instability in the export-led growth path is not as apparent. Let us look at the problems that could arise in this kind of growth.

It becomes necessary for the exporting country to keep its competitive advantage over the other countries if it seeks to remain the net exporter. This can be done by keeping the prices (in international currency) lower than the competitors. Let us see what does this require for the economy as a whole. We are assuming here markup pricing over the wage and raw material's cost. This relationship can be written as,

$$p^{US} = \epsilon^{US} \mu (wl + \alpha \epsilon^{RM} p^{RM})$$

where,

$$p^{US} = \text{Price of Chinese goods in US\$}$$

$$\epsilon^{US} = \text{Exchange rate of Yuan w.r.t. to US\$}$$

$$\mu = \text{Markup in the Chinese market}$$

$$w = \text{Money wages for Chinese workers}$$

$$l = \text{Labour coefficient}$$

$$\alpha = \text{Raw material coefficient}$$

$$\epsilon^{RM} = \text{Exchange rate of RM currency w.r.t. to Yuan}$$

$$p^{RM} = \text{Price of Raw materials from abroad in their local currency}$$

(1)

There are five instruments in China's control to maintain the competitive edge. First, since China has maintained a fixed exchange rate system, it can keep the exchange rate vis-á-vis US\$ (ϵ^{US}) low. Second, it could keep the profit margin low (μ). Third, the nominal wages of the workers (w) can be kept low. Fourth, the labour coefficient (l) can be kept low through technological advancement. Fifth, the raw material coefficient can be kept low again through technological innovation. Rest of the two factors are not in China's control especially if the currency of the raw material provider is pegged to the US\$.

The process of maintaining competitive advantage has serious ramifications for the entire economy. We can enumerate them as follows:

1. Exchange Rate Appreciation: Since the US has been running high trade deficits with China for a long period of time, it will try to if not reverse, at least halt this process. Already the US has been putting pressure on China to appreciate their currency. Even a Keynesian like Paul Krugman has been arguing strongly in favour of this. If China succumbs to this pressure, it would lose the competitive advantage. It is also possible that this would lead to a downward spiral in international trade through 'beggar thy neighbour' policies. Moreover, if China strives to still maintain the edge through cost reduction, it has its own perils as discussed in the next two points.

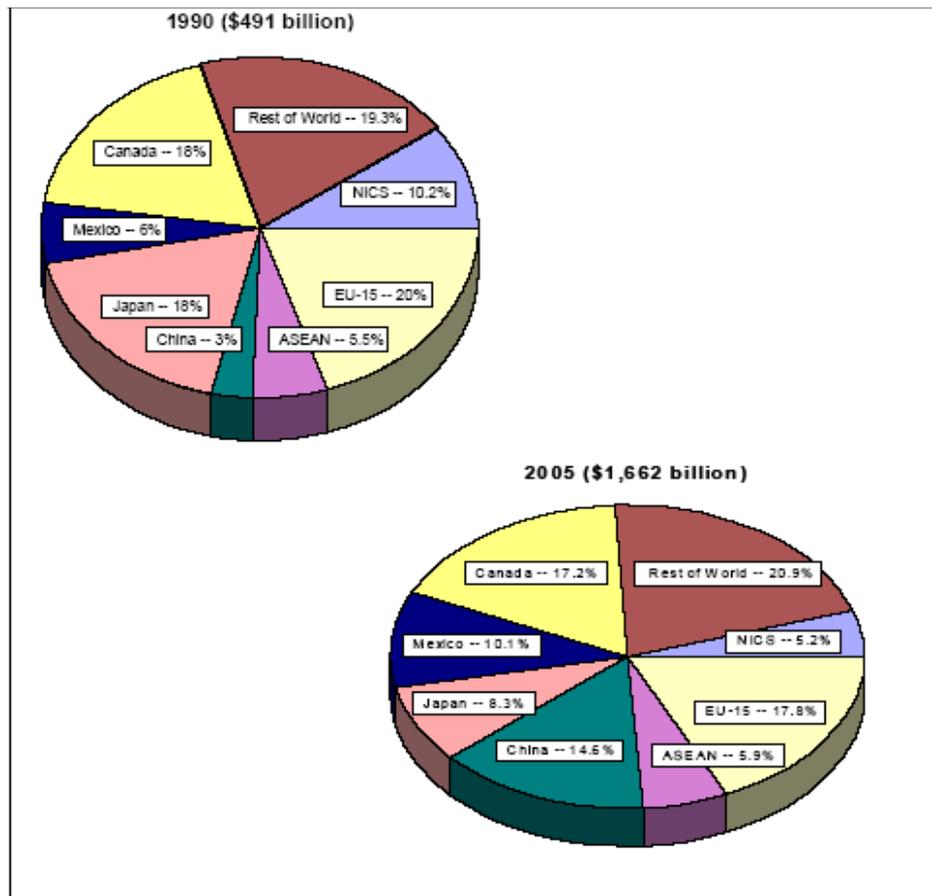
2. Lower Wages: Since it would be difficult to suppress the profit margins, the bulk of the pressure would come on maintaining lower costs. Lower wages, especially for unskilled workers could be a possible way of doing this. This, however, would add to the already declining share of wages in GDP and aggravate the underconsumptionist tendency.
3. Increasing Productivity: A more interesting and often misinterpreted case is the increase in labour productivity through technological innovation. Quite apart from its labour displacing capacity, it too has the potential of aggravating the underconsumptionist tendency. Any increase in labour productivity which is not passed on to the workers through increase in real wages *ipso facto* leads to a decline in the share of wages. And it is obvious that if the technological innovations are being introduced to decrease costs, productivity gains would not be passed on to the workers.
4. Increasing Dependence on Raw Materials: If China over a period of time becomes more dependent on raw materials like oil, it would be difficult to maintain the competitive advantage for long. Any inflationary crisis in the oil market would lead to an increase in the prices of the Chinese products. It is quite possible that to maintain the advantage, they would have to further increase the labour productivity or decrease workers' wages. Both these steps would have a disastrous implication as shown above.

Apart from these reasons, there is another factor that could play a role in destabilising the export-oriented growth. If the US does not succeed in persuading China to appreciate Yuan, they would for sure negotiate for opening up China's financial sector. This sector has advanced beyond boundaries in the US over the last two decades. Rentier interests in the US would argue for access to the Chinese capital market as an exchange for keeping the US market open for trade. It goes without saying that one of the primary reasons why China did not suffer severely during the crisis was because of their regulated financial markets. Once they are opened up, the chances of crisis in China would increase manifold.

2 Is China Mirroring Japan of the 1980s?

There seem to be striking similarities between the export-led growth path of Japan of the 1980s and China of today. First, the percentage of import of the US from China today is the same as that of Japan of the 1980s. In fact, the total share of Japan and China in US imports has remained constant. What has happened is that China has replaced Japan as a trade partner of the US (fig. 4).

Second, there was an increase in income inequality across both income groups and regions in Japan during this phase of growth. Tachibanaki (2006) calculates the gini coefficient for Japan between 1960-2002. He finds that while it remained stable for the 1960s and 1970s, it started increasing from 0.314 in 1981 to 0.381 in 1999.



Source: Thomas Lum and Dick K. Nanto "China's Trade with the United States and the World"

Figure 4: China Replaces Japan as Exporter to the US

Third, there was a drastic increase in labour productivity without a commensurate increase in the real wages in Japan, in much the same way as China of today. Itoh (2000) writes that labour productivity increased by 117% between 1975-85 and 33.9% between 1986-90. However, the real wages increased only by 5.9% and 8.7% respectively.

2.1 An overview of Japan since the 1970s

2.1.1 Japan during the Golden Age and Oil Crisis of the early 1970s

To correctly understand the Japanese trajectory since the late 1970s, a brief look at the years of 'golden age' of Japan would help. The average rate of growth for Japan during 1951-73 was 9.2%, the highest among the developed nations. This growth was primarily driven by the increased 'home market' arising out of high consumption. But such a high industrial growth also warranted a high dependency on primary products like oil. The inflationary crisis of 1973 which resulted in an unprecedented hike in oil prices seriously affected the terms of trade of Japan which decreased by 32% between

Table 1: An Overview of the Japanese Economy (1973-1998))

Years	Real GDP growth rate (%)	Gross fixed capital formation (%)	Wholesale price index (%)	Balance of state budget (trillions of yen)	Balance of trade (billions of dollars)
1973	8.8	13.7	15.8	0.2	-1.4
1974-75	0.8	-5.1	14.9	-2.8	-4.4
1976-79	5.2	5.1	3.1	-9.6	5.7
1980-83	3.5	0.3	3.9	-12.9	6.4
1984-85	4.8	5	-0.4	-11.7	40.2
1986	2.6	4.8	-4.7	-8.4	83.2
1987-90	5	9.9	-0.1	-5	68.5
1991-92	2.8	1	0.1	-7	92.2
1993-98	1	0.3	-1.1	-18.9	109

Notes: Annual average rate of change used. Averaged numbers may conceal wide fluctuations from year to year. For instance, the balance of trade in 1979 and 1980 was in large deficit, US\$-7.6 billion and US\$-10.7 billion, respectively.

Source: (Itoh, 2000, p.9)

1970-74. It is estimated that increase in the price of primary products alone accounted for 3.8% decline in Japan's rate of growth (Itoh, 2000, p.7).

2.1.2 Export and fiscal policy-led growth of the late 1970s

After the first oil crisis of the early 70s, Japan experienced a decline in growth rate which reached a low level of 0.8 %. However, this trend was reversed between 1976-79 where the average growth rate was 5.2%. This increase took place primarily due to increased trade surplus (through exports to the US) and increased government expenditure. He further says (Itoh, 2000, p.12),

It is remarkable that this huge increase in government debt did not fuel inflation. The annual rate of increase of wholesale prices fell to 3.0 per cent in 1975 and stayed at the moderate level of 3.1 per cent in 1976-79. This shows how deeply depressed domestic demand was on the side of consumption.

2.1.3 1980-85

The second oil crisis took a heavy toll on the Japanese economy. Itoh (2000) argues that a rise in oil price alone is estimated to have directly reduced Japanese GDP by 3.3 per cent. Over and above that, a revaluation in appreciation from 293 yen to 195 yen to the dollar between 1976-1978 reduced Japanese exports drastically. Also, the fiscal policy in the era of Thatcherism plunged in Japan. Thus, both the stimuli of the late 1970s decreased in importance resulting in a prolonged recession between 1980-83. Also the Japanese growth was tethered to the US, which itself witnessed a prolonged recession during the same time (see fig. 5).

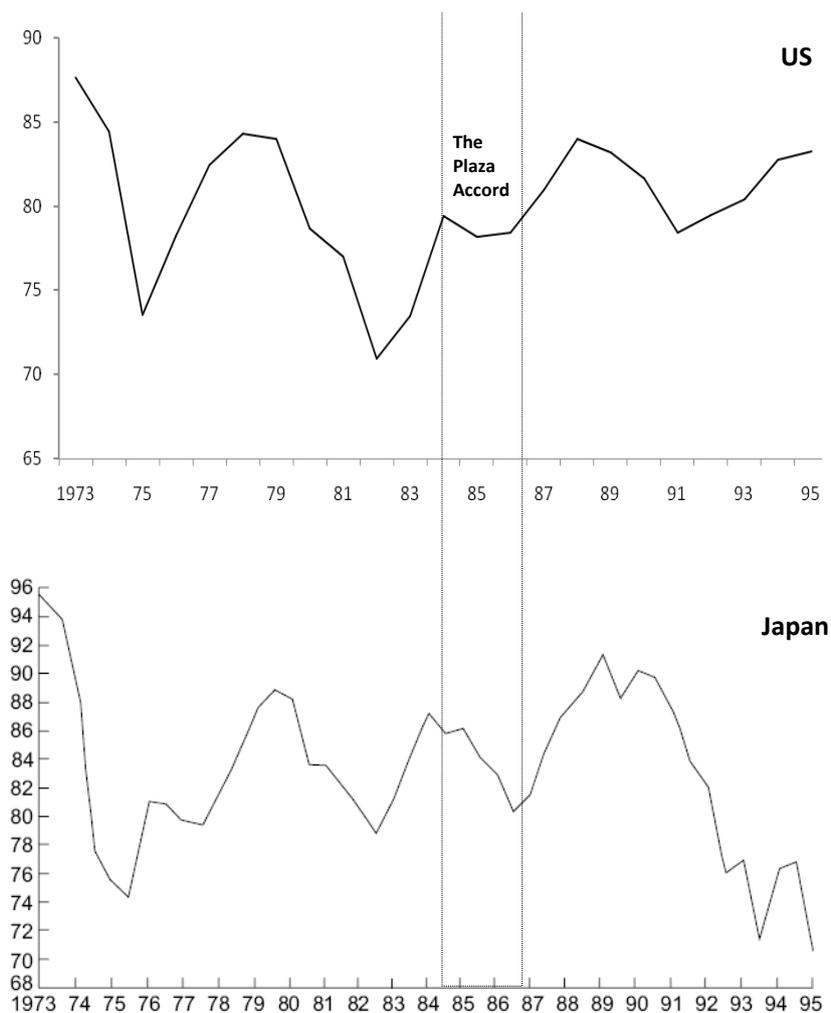


Figure 5: Capacity Utilisation in the Manufacturing Industries in the US and Japan

Japan's recovery started in the middle of 1983 for at least three reasons. First, there was a recovery in the US and other foreign markets. Second, there was a sharp rise in labour productivity through introduction of ME automation systems even as the real wages remained stagnant. Third, dollar appreciated from 203 yen at the end of 1980 to 251 yen at the end of 1984 (a rise of 23.6 per cent). The last two factors improved the competitive advantage of Japanese manufactured goods. As a result of this, Japanese exports expanded rapidly from US\$138.8 billion in 1982 to US\$175.6 billion in 1985. The trade surplus even surpassed that of Germany in 1983. Japan's export dependency reached a peak of 13.5 per cent in 1984.

The condition of US-Japan trade relationship seems very similar to today's US-China relationship. While the US was running huge trade deficits with Japan, it was maintained because Japan was investing a lot in the financial markets of the US. This was the phase when the movement of international finance capital peaked, thereby, bringing in speculation into the real economic activity as well. Growing financial investment by

Japan into the US put an upward pressure on the dollar which witnessed an appreciation.

Such appreciation of dollar made the US goods increasingly expensive in the world market. There was pressure from within the US to force Japan, Germany and the others to appreciate their respective currencies. This resulted in the infamous Plaza Accord which resulted in appreciation of yen from 240 to 150 per dollar in just eight months until May 1986. Obviously, such a sharp increase had a dampening impact on Japan's external balance while that of the US improved (see fig. 5 for the period under the Plaza Accord).

2.1.4 Speculative boom between 1987-90

Since Japanese capital was increasingly getting aligned to the US finance capital, the stock market run in NYSE in the late 1980s led to a speculative boom in the Tokyo stock exchange even as the real economy was in depression. The extent of this boom can be gauged from the fact that the Tokyo stock index increased from 13,137 yen to 18,701 yen (42 per cent). The average rose further to 26,646 yen by October 1987. The spectacular stock market boom created an inflated value of wealth of the rich in Japan resulting in wealth driven consumption. The problem with such a growth path, as we saw in the case of the US, is that it becomes dependent on the vagaries of the stock market. To use a Keynesian term, growth became a 'bubble in the whirlpool of speculation'. This could happen in Japan because the capital markets were made prize open to the US rentiers interests. Expectedly, the spectacularly high growth of the late 80s faced an equally disastrous decline when the bubble went burst.

The depression continued through the 1990s and has its after effects even today. It can be said that Japan has not fully recovered from the after-effects of the crisis of the 1990s. The problem was aggravated because of two additional reasons. First, after the Plaza Accord, Japan attempted to compensate for the decline in external demand through expansion of domestic demand. Government increased fiscal expenditure to prop up demand. Japanese government implemented a large-scale emergency supplementary budget of 6 trillion yen (about US\$40 billion) in 1987. Given that the fiscal expenditure was already high, little was left in the armoury of the government for the 1990s.

Second, the central bank in Japan had decreased its interest rates during the boom of the late 1980s. This was done in tandem with the decline in interest rates in the Federal Reserve rate in the US. The Bank of Japan reduced its discount rate from 5 per cent at the end of 1985 to 3 per cent in November 1986, and further to 2.5 per cent in February 1987. Such a drastic decline in the nominal rate of interest made the real rate of interest negative.

Given that both fiscal and monetary policies were used extensively during the late 1980s, there was little left for the government to do during the recession of the 1990s. Based on these similarities, one could raise certain questions about the Chinese growth today.

2.2 Some pointers towards a debate

1. Will the Chinese economy be able to resist the US pressure of appreciating yen?
2. Even if they resist it, will the US be able to pressurize to open the capital markets in China?
3. In either case, if the trade surplus in China falters as it did in Japan, will China be able to shift its effective demand towards the domestic market?
4. To improve the domestic market, China would have to act against the declining wage share, which could prop up mass consumption. But will China be able to do that, given that this would require a complete reorganisation of its industrial structure?
5. Can China diversify its external markets so that the dependence on US goes down? But if the currencies of these countries are pegged to the USD, any appreciation in yuan will have the same effect in these markets as the US market. Moreover, diversification of market will still not solve the aggravating problem of declining consumption given that export-led growth requires a continuous improvement in labour productivity.

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