

Unearthing the Roots of the Global Financial Crisis

The global financial crisis will not truly be over until the policies that led to large trade imbalances are sufficiently modified.

By Michael Pettis



EVER SINCE THE U.S. SUBPRIME CRISIS began in 2007-08, the world has struggled with a series of deep and seemingly-unrelated financial and economic crises. The most notable these days is the crisis affecting Europe, but it is not the just the United States and Europe that have been affected. The global crisis has also accelerated pressure on what was already going to be a very difficult transition for China, from an extremely imbalanced growth model to something more sustainable over the long term.

As a consensus about the need for a radical transformation of China's growth model develops, and it begins adjusting over the next few years, the impact of the global crisis will likely manifest itself in the form of a 'lost decade' or longer, featuring much slower growth and soaring government debt.

A Chinese adjustment will also bring with it adverse and perhaps even destabilizing shocks to developing countries that are heavily reliant on the export of commodities, especially non-food commodities: countries as far apart as Brazil and Australia — which have bet heavily on continued growth in China and the developed world — will be sharply affected when Chinese investment growth begins to falter.

In short, the crisis that began in the United States will adversely affect the entire world. In this article I will discuss the main driver of the crisis: global trade and capital imbalances, which have unfolded in almost textbook fashion.

The Perils of Under-Consumption

What has happened as the world adjusts to deep imbalances is neither unprecedented nor should have been unexpected. Nev-

ertheless, the tendency is to see the crisis as being caused by either the systematic deregulation of the financial services industry or the use and abuse of derivatives. When the crisis is viewed from a historical perspective, it is impossible to agree with either of these claims.

There have been many financial crises in history, dating at least from the Roman real estate crisis of AD 33 — which actually shared many characteristics of the 2007 crisis. Earlier crises occurred among financial systems under very different regulatory regimes with one thing in common: the use of derivatives was extremely limited or non-existent.

Perhaps it is just easier for people to focus on easily-understandable deficiencies. As Economist **Hyman Minsky** explained, "After a crisis, it will always be possible to construct plausible arguments — by emphasizing trigger events or institutional flaws — that mistakes or easily correctible shortcomings were responsible for the disaster." Minsky went on to argue that these 'plausible' arguments miss the point: financial instability has to do with underlying monetary and balance sheet conditions, and when these conditions exist, any financial system will tend towards instability. In fact, periods of *stability*, he argued, actually change financial behaviour in ways that cause destabilizing shifts and increase the subsequent risk of crisis.

Why do underlying monetary conditions become destabilizing? The classic explanation points to imbalances between *production* and *consumption*. According to this view, growing income inequality and wealth concentration leave household consumers unable to absorb all that is produced within the economy. One



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of the consequences is that surplus savings (i.e. the difference between total production and total consumption) grow to unsustainable levels, and because declining consumption undermines the rationale for investing in order to expand productive facilities, these excess savings are increasingly directed into speculative investments, or are exported abroad.

Most economists have tended to see imbalances between production and consumption as occurring and being resolved within a single country; but in fact, imbalances in one country can force obverse imbalances in other countries through the trade account.

In the late 19th century, economists **John Hobson** and **Charles Arthur Conant** argued that the leading capitalist economies turned to imperialism primarily in order to export surplus savings and import foreign demand as a way of addressing domestic savings imbalances, and this view has become widely accepted. Conant said that as we consumed ever-smaller shares of what we produced — perhaps because the wealthy captured an increasing share of income and their consumption did not rise with their wealth — domestic savings eventually exceeded the ability for domestic investment to serve ‘legitimate’ needs, which was to expand domestic capacity and infrastructure to meet domestic consumption.

In short, excess savings themselves reduce domestic consumption, and so reduce the need to expand domestic production facilities, and when this happens, the major industrialized nations have to turn abroad to export their excess savings, thereby importing foreign demand for domestic production. As it was in the past two decades, this need to export savings was at the heart of trade and capital flow imbalances during the last decades of the 19th century and the first decades of the 20th. It was, however, the most industrialized countries that were the source of excess savings in Conant’s day, whereas today, the major exporters of excess savings range from rich countries like Germany and Japan to very poor countries like China.

Kenneth Austin, an economist with the **U.S. Treasury Department**, recently made an explicit comparison between the two periods:

The basic idea is that over-saving causes insufficient demand for economic output. In turn, that leads to recession and resource misallocation, including excessive investment in marketing and distribution. This is a direct challenge to a core thesis of the classical economists: ‘Savings

are always beneficial because they allow greater accumulation of capital.’

Hobson took his excess savings theory in another direction in *Imperialism: A Study*, published in 1902. In a closed economy, he wrote, excess savings cause recessions, but an open economy has another alternative: domestic savers can invest abroad. Hobson attributed the renewed enthusiasm for colonial conquest among the industrial powers of the day to a need to find new foreign markets and investment opportunities:

Increasing foreign investment requires earning the necessary foreign exchange to invest abroad, which requires an increase in net exports. So foreign investment solves two problems at once: it reduces the excess supply of goods and drains the pool of excess saving. The two objectives are simultaneously fulfilled because they are, in fact and theory, logically equivalent.

When domestic consumption has been insufficient to justify enough domestic investment to absorb the high savings (that were themselves the result of low consumption, usually because the working and middle classes had too small a share of total income) countries have historically exported capital as a way of absorbing foreign consumption. With the exporting of these excess savings, and the concomitant importing of foreign demand, international trade and capital flows necessarily resulted in deep imbalances.

Two Other Possibilities

The ‘under-consumptionist’ argument’ is not the only theory that attempts to explain trade imbalances; there are at least two others.

MERCANTILISM THEORY. The most common explanation for trade imbalances is ‘mercantilism’. Broadly speaking, mercantilist countries put into place policies — including import restraints and export subsidies — aimed at generating a positive balance of trade in which the country *exports* more than it *imports*.

The defense of mercantilism is that it permits the practitioner to generate net inflows of assets that can be accumulated for a number of purposes. It isn’t always clear exactly what these purposes are, but the main justification, historically, seems to have been the ability to wage war.

During the classic mercantilist age, a positive balance of

trade resulted in the accumulation of gold and silver, and this assured the ability to hire soldiers and pay for armaments. Today, of course, countries are more likely to accumulate assets mainly in the form of foreign exchange reserves at the central bank or private ownership of foreign assets. The hoard of central bank reserves is driven not so much by military needs as by the need to defend the stability of the currency, maintain payments on foreign loans and obligations, and most importantly, guarantee access to imported commodities in times of financial stress.

Although countries like China, Japan, Korea and Germany have been accused of mercantilism for many years, this particular charge isn't really a satisfactory explanation of what they do. Clearly, for a highly-volatile developing country there are benefits to accumulating a certain amount of foreign reserves; but this cannot be the whole explanation. Given how domestic monetary policies are distorted by the accumulation of reserves, it is hard to explain why rich countries employ mercantilist policies, or why poor countries like China accumulate levels of foreign exchange reserves that far exceed even the most generous estimate of what would be appropriate. In either case, mercantilism simply does not make sense.

It is worth mentioning that countries like China, Japan before 1990, South Korea and other Asian Tigers are, properly speaking, neither mercantilist nor export driven. They are, particularly in the case of China, investment-driven economies whose large trade surpluses were, or are, simply a necessary residual of policies that—consciously or not—forced up the savings rate to fund domestic investment. The subsequent imbalances that are created can become seriously destabilizing, both for the countries that employ these policies and for the world.

INFANT INDUSTRY THEORY. In 1791, America's first Treasury Secretary **Alexander Hamilton** argued that it was in the best interests of the U.S. that certain industries be encouraged to develop quickly because the externalities (although he did not use this word) associated with these industries were significant.

The problem, he said, was that because British and other European industrialists were so far advanced in terms of productivity, Americans simply would not be able to compete for many years unless the government imposed tariffs on foreign-made goods. The goal of protection, in this case, was to create enough space for American industrialists to catch up to Europeans; once they did, the tariffs could be removed.

Although the infant industry argument is still often used to explain trade intervention, it is also an unsatisfactory explanation for current imbalances. Of the three largest surplus nations, two of them — Germany and Japan — can hardly be said to be technologically backward and in need of protection. The third, China, discourages the brutal domestic competition that is necessary to drive technological innovation and productivity growth behind protectionist barriers, so trade protection in China is unlikely to lead to rapid growth in innovation.

And the Winner Is...

We are left with under-consumption as the most likely cause of current global trade distortions. Of course, trade imbalances don't always lead to crisis. In any well-functioning global system, there are always likely to be small and temporary imbalances in trade flows. In some cases — primarily in the case of countries in the midst of a long-term investment boom — like the U.S. for much of the 19th century — trade imbalances can be sustainable and even persist for years without leading to crisis. Even in the case of the U.S. in the 19th century, however, there were financial crises nearly every decade or so, some of which were linked to trade imbalances.

Even otherwise-sustainable trade imbalances can lead to crisis when they create fragile national balance sheets. This can happen because trade flow imbalances, of course, require their obverse — capital flow imbalances, and capital flows are often structured in ways that are instable and lead to fragility in national balance sheets.

Still, trade imbalances driven primarily by high levels of investment in trade-deficit countries need not be destabilizing. They can persist for many years, but eventually the system automatically adjusts when many years of productive investment begin to generate the rising production of goods and services and there is a reversal in these imbalances. This reversal occurs as either the cause or the consequence of a reversal in capital flows.

Countries that repay foreign investment must run current account surpluses, just as countries that run current account surpluses must be net exporters of capital. In other cases, countries that run trade deficits for many years not driven by surging domestic investment necessarily see a rise in foreign capital inflows (because trade deficits must always be funded by foreign investment). In this case, the liabilities generated by the inflows are not associated with an increase in domestic asset growth,

How China's Rebalancing Will Affect the Global Economy: Four Predictions

1. The price of hard commodities will drop sharply.

China consumes a disproportionate share of the world's hard commodities, such as aluminum, copper and iron ore. Adjusted for GDP, the country buys four to ten times as much of these as the rest of the world, and its appetite has driven most of the global increase in commodity demand during the past two decades. As investment growth slows, so will China's demand for hard commodities, whose prices may consequently drop, perhaps by as much as 50 per cent over the next few years.

2. Industries that profit from building infrastructure or manufacturing capacity will suffer.

Rebalancing will sharply reduce the growth of aggregate spending on construction equipment, heavy manufacturing, transportation and other sectors that have historically benefited from China's explosive surge in investment. Government policy will influence which sectors will suffer most.

3. Companies that produce consumer goods will be marginally affected overall, while specific sectors will do much better or worse.

China's rebalancing requires household incomes to continue growing faster than GDP. The composition of this growing consumption, however, may change dramatically: first, rebalancing means that the middle class will expand, reducing the relative importance of the rich and poor in the country's consumption profile; and second, political constraints will drive how the cost of rebalancing is distributed amongst powerful vested interests, which will affect how benefits are distributed amongst households.

4. Countries, especially developing ones, that rely heavily for growth on manufacturing will benefit.

Low unit-labour costs, repressed interest rates and an undervalued currency are at the heart of China's export competitiveness. By definition, rebalancing increases all of these and will significantly reduce China's export competitiveness in the near term. How foreign manufacturers benefit will depend on political decisions, including whether capital- or labour-intensive industries bear the brunt of the adjustment.

-Michael Pettis in *McKinsey Quarterly*

and so foreign obligations rise at an unsustainable pace.

Although trade imbalances can exist naturally, not all of them are 'natural'. When imbalances that are not associated with a large increase in productive investment in the deficit country become large and persist, it is almost always because policy distortions, or distortions in the institutional framework constraining or governing these trade flows, have prevented the adjustment from taking place.

Large and persistent trade imbalances, in other words, are almost always caused by distortions in financial, industrial or trade policies. These distortions can prevent adjustments for many years, but large imbalances ultimately are unsustainable because the capital flows that finance them can be reversed only with a reversal of the trade imbalances. Eventually these imbalances will adjust, in spite of policy and institutional constraints, but in this case the adjustment is often violent and can come in the form of a financial crisis.

In this sense, there is nothing surprising about the global financial crisis: it was simply the necessary and chaotic adjustment after many years of policy distortions that forced large and persistent capital imbalances. The main imbalances of recent years were the very large trade surpluses during the past decade of China, Germany and Japan, and the huge trade deficits of the United States and peripheral Europe.

None of what is happening today is new, but what is often forgotten is that policies in the country or countries that first suffered from the crises — usually the trade deficit countries — have not always caused the distortions. It is important to recognize that these imbalances had their roots in policy distortions in both the countries that ran large trade deficits and those that ran large trade surpluses. For the former, the large deficits led to unsustainable increases in debt and, ultimately, to the deleveraging process necessary to restore balance. This deleveraging process is at the heart of the global financial crisis.

Why All the Confusion?

There are three key areas of muddled thinking when it comes to discussing global imbalances.

1. CONFUSION ABOUT THE CAUSES OF SIGNIFICANT TRADE IMBALANCES.

Although in a well-managed global economy with few distortions and flexible financial systems there are always likely to be countries with account surpluses and deficits, it is worth repeating

that very large persistent surpluses and deficits are almost always the result of distorted policies in one or more countries.

There are many ways in which these distortions can occur. It is easy to think of trade tariffs and currency manipulation as forms of trade intervention, but while they certainly do cause distortions in trade, they do not do so for the reasons we generally assume: their impact on trade is not directly through relative price changes but rather indirectly by changing the relationship between consumption and GDP. By understanding how and why they actually cause trade distortions, we can understand more



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generally how a whole range of industrial, tax and financial policies that seem unrelated to trade can, in fact, cause significant trade distortions.

2. CONFUSION ABOUT THE RELATIONSHIP BETWEEN TRADE, THE SAVINGS RATE, AND INTERNATIONAL CAPITAL FLOWS. The three are linked, of course, but the way they are linked is more complex and subtle than most people recognize: policies that affect trade balances usually do so by affecting the savings and investment rates, both at home and abroad, and changes in savings and investment rates automatically affect capital flows.

It is important to understand these relationships in order to understand how policies in one country can force corresponding changes in another, and to understand that the savings rate is not an independent variable that can be altered with the right moralistic exhortations. It can only be altered in an orderly way via changes in the underlying policies—both at home and abroad—that led to excessively high (or low) savings rates in the first place. Otherwise the savings rate will ultimately adjust anyway, but it will do so in a disorderly way—with abrupt disruptions to international trade.

3. CONFUSION ABOUT THE ROLE OF THE U.S. DOLLAR AS THE GLOBAL RESERVE CURRENCY (AND MORE GENERALLY, WITH THE ROLE OF CENTRAL BANK RESERVES.) There is a tendency to believe that global trade is denominated primarily in U.S. dollars, and that countries are forced to accumulate dollars if they want to accumulate foreign currency reserves. It is also widely believed that the widespread use of the U.S. dollar confers enormous advantages upon the U.S. In fact, reserve currency denomination has little to do with U.S. power or dominance, and much more to do with trade policy in foreign countries and an accommodating financial and monetary system in the U.S.

The astonishing accumulation of dollar reserves in the past decade has been the consequence — sometimes intended and sometimes not — of a wide range of policies aimed at generating growth in those countries, and this is inextricably linked to the causes of the global crisis. Contrary to popular belief, it is not in the interest of the United States that countries continue to accumulate mostly dollars in their central bank reserves. In fact, excessive use of the U.S. dollar actually forces up either American debt or unemployment; it is more of a burden than a privilege. For that reason it is actually in the best interest of

the U.S. — although perhaps against the best short-term interest of China and other countries that seek to grow rapidly — that the U.S. government place restrictions on the ability of foreign countries to hold U.S. dollar reserves. This will both benefit the American economy and stabilize the global environment.

In closing

The global financial crisis will not be truly over until the institutional framework that led to large trade imbalances has been sufficiently modified. Unfortunately, much of the debate on how to avoid similar crises in the future is muddled and misses the point. The fact is, Japanese interest rates, American mortgage derivatives and copper mining in Chile are all part of a single system in which distortions in any one part must have automatic consequences for all the others. Financiers in São Paulo earn substantially higher compensation than their peers in London, in part, because Chinese households receive an artificially low return on their deposits; and there are huge tracts of empty homes outside of Dublin, in part, because of the overvaluation of East Germany's currency after reunification.

If we misunderstand the root causes of the imbalances that led to the global financial crisis, it is unlikely that we will choose policies that enable us to work our way out of them. Deficit country austerity may indeed be part of the correct prescription, but if it is not more than fully matched with surplus-country reflation, it cannot possibly succeed without very negative effects, including a sharp rise in global unemployment. **RM**



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