

Sharing the Pain: The Global Struggle Over Savings

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SUMMARY

- In a world of excess global savings and too little global consumption, a rise in the U.S. savings rate will necessarily force equivalent and difficult adjustments elsewhere.
- The benign forms of these adjustments involve either rising global investment or a surge in Chinese consumption. Given persistently high unemployment in the world's major economies, the former is extremely unlikely.
- The latter is also unlikely. Chinese savings have been high, and consumption low, because of government policies that constrained the growth of household income in order to subsidize Chinese manufacturing prowess. The fiscal and credit stimulus of 2009 has only exacerbated those policies, making it extremely unlikely that Chinese consumption will surge over the medium term.
- Without a rise in global investment or a surge in Chinese consumption, a rising U.S. savings rate will require either a contraction in U.S. gross domestic product (GDP) or a sharp slowdown in Chinese GDP growth. The way in which the economic pain is distributed will depend largely on the two countries' trade policies.
- This makes international trade the arena for much more potential conflict. It is in the best interest of both the United States and China that the two countries coordinate policies to manage the process in the least disruptive way.

In September, the Obama administration imposed tariffs on Chinese tires. In October, the U.S. Department of Commerce announced it would launch an investigation into imports of seamless steel pipes from China. That same month, the U.S. Chamber of Commerce and the U.S.–China Business Council, two groups that in the past have defended Chinese policies, testified to the Office of the U.S. Trade Representative that Chinese contracting rules, technical standards, and licensing requirements were protectionist.

The world is adjusting from the global imbalances of the past decade, but the transi-

tion will not be easy or automatic. Part of this adjustment will require an increase in the U.S. savings rate as U.S. households are forced to repair their tattered balance sheets and U.S. banks rein in consumer lending. In the best of possible worlds, the rise in U.S. savings would be perfectly matched by an increase in non-U.S., mainly Chinese, consumption, but for reasons discussed below, it is very unlikely that Chinese consumption will be able to rise to the occasion. If U.S. savings rates rise, and if Asian and, especially, Chinese high savings rates persist, the world economy must adjust either in the form of higher investment or



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slower growth. Since the former is unlikely, any adjustment will probably involve slower growth, which would be distributed across various economies through the trade account. This makes international trade the arena for much more potential conflict.

At first glance, this might not seem to matter too much to China. Even as the United States and Europe are still struggling to recover from the global financial crisis, China—despite rapidly declining exports—is growing faster than most experts believed possible six months ago and is very likely to exceed its target of 8 percent GDP growth for 2009. But far from addressing underlying imbalances, China's growth is hiding even greater vulnerability to unrelenting changes in the U.S. economy. These changes may force China into a decade of much slower growth, domestic political pressures, and more difficult international relations.

This outcome would hurt not just China, but also the United States and the world. In the 1920s, frustrated with arguments over debt repayments and not trusting the motives of the European powers, Washington refused to play its newly earned role as a major stakeholder in the new global order. From the League of Nations to the multilateral currency agreements ending in the failed 1933 London Conference, U.S. truculence doomed several important global initiatives to failure, which most historians now believe worsened the political and economic imbalances that led to the various crises of the 1930s.

The same can happen with China. To best resolve the most important problems facing the world in the next decades—including problems of global warming, nuclear proliferation, international terrorism, disease, the use of water and energy resources, and poverty—China must remain a fully committed member of the institutional framework that will evolve from the global crisis. But it is not at all certain that this will happen. How the major economies coordinate policies in the next few years will have a large impact on whether rela-

tions among the United States, China, and Europe are cooperative or mistrustful.

The Unwanted Rise of Savings

At the root of the global imbalance were the distorted savings and spending relationships within and between China and the United States. While Chinese private consumption was the lowest recorded among large economies—probably in all of modern history—and its savings rate the highest, U.S. consumption surged to its highest levels and its savings rates dropped to zero. At the same time, China and the United States ran the largest trade surpluses and deficits, respectively, ever recorded as a share of global GDP.

This was not a coincidence. Savings and investment must balance globally, and high savings and low consumption in one part of the world generally require the opposite elsewhere. Economists may disagree about the direction of causality, but surpluses and deficits on trade and investment accounts are the way savings match investment across the global economy. As long as China's rising savings rate was met by the declining savings rate of Americans, a Chinese trade surplus and U.S. trade deficit helped balance savings and investment at the global level.

But the global financial crisis has changed this relationship. As part of its adjustment to the crisis, the United States must undergo a long deleveraging process that will require a decline in consumption and a rise in the savings rate, along with the likely corollary, a contraction in the U.S. trade deficit. President Obama's administration even claims that it wants permanently to restructure the U.S. economy away from its persistent low savings rate and to increase the role of exports as an engine of GDP growth.

Of course, that can't happen without countervailing changes in the global economy. If U.S. savings rise, and consumption drops without an equivalent rise in global investment, the impact on the global economy will require the obverse—that foreign, mostly Chinese,

savings decline and consumption rise nearly as quickly as U.S. consumption drops. Absent that compensation, lower overall consumption will force global GDP into lower growth over the medium term. Is global investment likely to rise in the near future? Probably not. In fact, with Europe and the United States struggling with high and rising unemployment, global investment is probably more likely to decline, which would put even more downward pressure on global GDP growth.

For now, it seems that China and the United States are trying to resolve domestic problems with policies that are in conflict, and this conflict is likely to continue roiling the global economy for years to come. That is because although China desperately needs to increase consumption, Beijing's policies to lessen the employment impact of the collapse in exports will ultimately prevent consumption in China from rising nearly as quickly as necessary. Persistent high savings in China will clash with rising savings in the United States.

The Limits to Chinese Consumption

Contrary to popular belief, high Chinese savings are not caused mainly by Confucian cultural values or a natural propensity to thrift. Chinese are eager consumers, as any visit to Beijing's Wangfujing or Shanghai's Nanyang Lu, the two premier shopping streets in China, will show. But growth in household consumption is determined by the growth rate of household income and wealth, not by the economy's growth rate. If household income grows more slowly than national income and there is no explosion in consumer credit, consumption growth will lag behind GDP growth and the national savings rate, the difference between the two, will automatically rise.

Although China is still a very poor country, there is no question that Chinese household income has grown substantially over the past few decades. It has not, however, grown nearly as quickly as GDP. While China's GDP grew at an annual rate of 11 to 12 percent from 2002 to 2007, for example, MIT economist

Yasheng Huang estimates that household income grew at a much lower annual rate of 9 percent. If we were able to adjust Huang's measure to take into account changes in other forms of household wealth—which are described below—growth in household income would have been even lower. That is

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why consumption has declined as a share of national income and why China's total production has exceeded its total consumption by a large and growing amount. It is at the root of China's high savings rate.

Why haven't Chinese households maintained their share of national income? The main reason is that the rise in household income was constrained, especially in the past decade, by industrial policies aimed at turbocharging economic growth. These policies systematically forced households implicitly and explicitly to subsidize otherwise unprofitable investment in infrastructure and manufacturing. Although these policies powered employment and manufacturing growth, they also led to wide and divergent growth rates between production and consumption, and so forced a rising trade surplus. These policies included:

- An undervalued currency, which reduces real household wages by raising the cost of imports while subsidizing producers in the tradable goods sector.
- Excessively low interest rates, which force households, who are mostly depositors, to subsidize the borrowing costs of borrowers, who are mostly manufacturers and include very few households, service industry companies, or other net consumers.*

* The Chinese banking system mostly directs credit to investment, manufacturing, and the state-owned sector and not to consumers. Given very weak credit analysis and risk management in the banks, and the long tradition of policy-directed lending, previous forays into consumer lending have typically resulted in large amounts of nonperforming loans, thus low interest rates have had little effect in spurring consumer credit. What is more, in the United States, declining interest rates tend to increase the wealth of households, most of whose savings consist of stock and bond portfolios or real estate, and so cause households usually to increase consumption, whereas in China, where most savings are in the form of bank deposits, and are primarily precautionary, central-bank-mandated reductions in interest rates reduce the value of savings and generally cause households to cut back on consumption, increasing the share of Chinese household income directed to savings.

- A large spread between the deposit rate and the lending rate, which forces households to pay for the recapitalization of banks suffering from nonperforming loans made to large manufacturers and state-owned enterprises.

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- Sluggish wage growth, perhaps caused in part by restrictions on the ability of workers to organize, which directly subsidizes employers at the cost of households.
- Unraveling social safety nets over the past two decades and weak environmental restrictions, which effectively allow corporations to pass on to workers and households the social cost that the businesses once carried.
- Other direct manufacturing subsidies, including controlled land and energy prices, which are also indirectly paid for by households.

By transferring wealth from households to boost the profitability of producers, China severely hampered its ability to grow consumption in line with growth in the nation's GDP. Of course, the gap between production and consumption is the savings rate, and as production surged relative to consumption, a necessary corollary was a rising Chinese savings rate.

China's Stimulus Package Will Hamper Consumption Growth

Beijing's reaction to the financial crisis may ultimately exacerbate its dependence on exports. In their understandable concern that a collapse in U.S. imports would cause a surge in Chinese unemployment, Beijing policy makers reacted to the crisis with their standard tool—soaring investment on top of what was already the highest investment rate for any major economy in recorded history. They poured even more resources into infrastructure investment and manufacturing, and in so doing engineered the biggest fiscal and credit expansion of any of the major economies.

But little of this effort went to increase net consumption. Although keeping factories open unquestionably increases total consumption by raising employment, boosting production even more still does not resolve the problem of Chinese overproduction. Because the only economic purpose of investment is to increase future production, ultimately the accelerating infrastructure investment that is needed to keep employment high is not only unsustainable, but it also does not resolve under-consumption in the medium term. It merely pushes the problem forward for a few years.

What's more, the Chinese stimulus package has poured credit into increasingly questionable projects and will almost certainly increase the direct and indirect subsidies to investment and manufacturing. These policies might boost the economy in the short term, but if they lead to wasted investments and a rising level of nonperforming loans—which they almost certainly would—Chinese households will be forced once again to foot the bill, primarily through sluggish wage growth and low deposit rates. The consequent negative impact on household income will make it difficult for them to spend as lavishly as everyone hopes. This increase in current and future production, with no concomitant increase in domestic consumption, would leave China more vulnerable than ever to global, and specifically American, net consumption.

China's leaders say that they are eager to goose domestic consumption, but if households are forced to pay to recapitalize the banks and to make the surge in unprofitable investments viable, it is unreasonable also to expect them to splurge on consumption. Historical precedents suggest that it will take many years for a country as dependent on exports as China to restructure its economy toward domestic spending. In the end, the only effective way for China to increase its reliance on domestic consumption is to reverse the transfer of income from households to the state and corporate sector.

For consumption to rise as a share of GDP, household income must also rise as a share of GDP. In the near term, however, this is much more easily said than done. Removing the subsidies and returning income to the household sector would cause a sharp loss in China's export competitiveness and could cause a surge in unemployment, which, paradoxically, could slow consumption growth during the adjustment period. But without reversing this income transfer from consumers to producers, hoping for a surge in consumption is futile.

The Pain of Rebalancing Is Distributed Through Trade

Why does all of this matter to trade tensions? If the rising savings rate in the United States is not met by rising Chinese or foreign consumption or rising global investment, the world will have to choose largely one or both of two likely adjustments:

1. Although the U.S. household savings rate rises, there is no actual increase in total U.S. savings. This seemingly paradoxical outcome might occur at first because of a sharp rise in government borrowing, but a continuous rise in government borrowing is neither sustainable nor in the best interests of the medium-term rebalancing of the U.S. economy. The alternative is for U.S. GDP to shrink, so that although Americans sharply reduce their consumption, it is balanced by the decline in their total income, and there is consequently no increase in savings.
2. Chinese economic growth slows sharply and begins to grow less quickly than consumption, which will automatically cause a decline in the savings rate. For the past several years, Chinese consumption has been growing at a healthy 8 to 9 percent annually, while GDP has been growing by 11 to 12 percent. By definition this resulted in a growing savings rate. To reduce growth in Chinese savings, China's GDP growth rate will have to drop significantly below

its rate of consumption growth. Even if we assume, somewhat heroically, that a sharp decline in GDP growth will not reduce consumption growth rates, this suggests that China's GDP will grow at rates of below 7 to 8 percent.

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Which of these outcomes is the more likely depends to a large extent on government policies in both countries, especially in relation to trade. If the U.S. trade deficit remains high, and especially if it rises in the future, U.S. GDP growth will probably slow or even contract. Without a sustainable surge in investment, a rising U.S. trade deficit means that U.S. GDP growth must be less than the already sluggish growth in U.S. consumption. Of course, if investment declines, U.S. GDP growth would be even lower.

If the United States is determined to bring down the trade deficit quickly, doing so would help prop up U.S. GDP growth because a contracting trade deficit is expansionary for the economy—allowing GDP to grow more rapidly than consumption. This scenario, however, is far from optimal for China. A contracting U.S. trade deficit would almost certainly force a contracting Chinese trade surplus, making China's growth rate less than its consumption growth rate (assuming accelerating investment is unsustainable over the medium term). Reducing the trade deficit quickly would allow the United States to avoid much of the brunt of the adjustment, and China would be forced to absorb it.

The U.S. attitude toward its trade deficit, and to a lesser extent Europe's attitude toward absorbing part of this deficit, are key factors in determining the distribution of the burden of the postcrisis global adjustment. With rising unemployment in Europe and the United States, it is hard to see that either of the two

countries will be willing to absorb much more of the cost of the adjustment. This will make discussions over trade harder than ever.

Resolving the Conflict

While some in the United States may relish a difficult economic transition for China, no serious policy maker should consider such a prospect as anything other than harmful to long-term U.S. interests. For all the problems China will face, its role in resolving the main issues facing the world will only increase. For this reason, it is important that the world help reduce the cost of China's economic transition. An economically difficult transition would undermine reformers in China who understand China's role in the global economy and would weaken the tendency for international cooperation. A mistrustful China, with pro-Western reformers undermined by nationalist hostility, would not be good for the United States.

The world needs serious policy coordination to avoid the consequences of a difficult economic transition for China as U.S. savings rates rise. This will not be easy, especially because it will require that the United States slow down the pace of its adjustment and accept a more gradual recovery of its tradable

goods sector than it might otherwise achieve through greater trade hostility.

For policy coordination to work, Beijing and Washington (and Brussels) should work out a multiyear plan in which China commits gradually to taking the necessary and difficult steps toward rebalancing its economy and reducing its net exports—by raising interest rates, liberalizing the financial system, boosting workers' wages, reforming land ownership, and revaluing the currency—in exchange for a commitment by the United States to slow the contraction in U.S. demand by boosting domestic investment and to keep markets open for Chinese exports while it is managing the transition. Europe will also need to agree to help reduce the burden for the United States.

These policies in China, if they are truly to assist the rebalancing process, will have the effect of transferring income away from the corporate and state sectors and back to Chinese households, allowing Chinese consumption to grow relative to the economy. But there are two significant costs to these policies. First, China's manufacturing sector is thoroughly addicted to the variety of subsidies provided indirectly by households. If Chinese state-owned companies were to pay a reasonable rate of interest on their borrowings, for example, more than 100 percent of

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How Does the World Adjust to Rising U.S. Savings?

Assume a two-country world, in which the United States has a low savings rate, and China a high savings rate. Because investment exceeds savings in the United States, it must import Chinese savings, and so runs a trade deficit with China. In China, savings exceeds investment, so it exports the balance and runs a trade surplus.

What happens if the U.S. savings rate were suddenly to rise? The most likely scenarios are:

POSITIVE SCENARIOS

- 1) Global investment rises in step with the increase in U.S. savings. If the increased investment occurs in the United States, the U.S. trade deficit does not contract because investment continues to exceed savings and the United States must import the balance, but the trade deficit is sustainable because it is financed by (presumably) productive investment. If the increased investment occurs in China, the U.S. trade deficit contracts. Note that if, instead, global investment declines, the following three scenarios are exacerbated.
- 2) Chinese consumption surges in line with the rise in U.S. savings, and both the U.S. trade deficit and the Chinese trade surplus contract. The surge in consumption, which will form the upper limit of Chinese GDP growth in the coming years, allows China to continue growing quickly, while the contracting U.S. trade deficit is expansionary for the U.S. economy.

their profits would disappear, suggesting that China's manufacturing prowess is anchored in subsidies. Removing them will be very painful at first as businesses struggle to adjust to a more competitive world.

Second, reforms of this nature are as much political as they are economic. Eliminating the mechanisms by which China's policy makers can transfer income from households to manufacturers will reduce their control over the commanding heights of the economy, and it will sharply reduce the power and leverage the ruling party has over businesses and local governments.

Still, China probably has little choice. Its growth model requires that the United States be able to absorb the overcapacity it produces, and if the United States is serious about raising its savings rate and correcting domestic imbalances, China's growth model will have outlived its usefulness. The transition will be difficult but necessary. One way or another, Chinese consumption must grow relative to the overall economy if it is to drive China's economic growth, and that can happen only if household income grows more quickly than the economy for several years.

The recent high growth rates in China have disguised the fact that China may be more vulnerable than ever to a continuing

global slowdown. Because the United States controls the dwindling amount of the most valuable economic resource in the world, net demand, the United States will determine the pace of the global adjustment. If the United States recognizes both the difficulty of China's adjustment and the fact that the pace of China's adjustment will depend on the pace of the U.S. adjustment, it can work with China to manage the process in the least disruptive way for China in the short term and for both countries in the long term.

The process will be difficult even in the best of circumstances, but without coordination the Chinese savings juggernaut will clash with American attempts to force savings up. The clash will cause the world to adjust in unpredictable ways, including with more trade tension and rising hostility within China. An outcome like that would both hurt China and not benefit the United States. ■

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NEGATIVE SCENARIOS

- 1) The U.S. savings rate rises, but total U.S. savings do not rise because U.S. GDP contracts. Because a contracting U.S. GDP will almost certainly lead to a decline in U.S. investment, the trade deficit will contract as domestic savings rise relative to domestic investment.
- 2) Chinese consumption continues to grow at the same or a lower pace than the 8 to 9 percent of the past several years. Chinese GDP growth falls significantly below that level as the Chinese savings rate is forced to adjust downward to match the rise in U.S. savings. Assuming the savings rate falls faster than investment, China's trade surplus contracts.

In all cases, the global rebalancing takes place, as it must, but there are both high-growth scenarios and low-growth scenarios that accommodate the rebalancing. If we assume that neither global investment nor Chinese consumption will rise enough to force a positive outcome, the distribution of the necessary slowdown in global growth outlined in the last two scenarios will depend on the trade dynamics as producers in both countries struggle to access dwindling U.S. consumption. If the U.S. savings rate rises with no contraction in the U.S. trade deficit, most of the pain of the adjustment will take place in the United States. If the U.S. trade deficit falls in line with the rise in the U.S. savings rate, most of the pain of the adjustment will take place in China.

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