
Michael Pettis, *The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy*. Princeton, NJ: Princeton University Press, 2013, 232 pp. ISBN: 0691158681 (hardcover).

During 2008–2009, we were hit by the *Great Recession*. Leading up to this greatest financial crisis since the *Great Depression* was the *Global Imbalance*, a phenomenon and a puzzle at that time whether the USA would be able to sustain huge trade deficits with the rest of the world. We know now that the trade deficits were in fact not sustainable. We are now in the aftermath of the correction period, the *Great Rebalancing*.

Michael Pettis uses the majority of the chapters in the book to decipher the cause of the puzzle. At the end, he also outlines his predictions on how the readjustment will likely take place, and the challenges the global economy is facing. The word 'great' in the book's title reflects the author's sentiment: it will be an extraordinary event in history, and will likely be very difficult to achieve. To make it a comprehensive book and to help attract a wider audience, Pettis covers policy actions in many countries: China, USA, Japan, Germany and the European Union. Despite this broad coverage, the focus is unwaveringly on the trade relations between the USA and China. Given Pettis' background as a former American investment banker and now an economics professor at China's Peking University, this came as no surprise.

Pettis proposes an 'underconsumptionist' theory at the very beginning (p. 6). He borrows this from the seventeenth-century British economist and philosopher Thomas Mun. In his 1664 book, *England's Treasure by Foreign Trade*, Mun rationalized 'a much more sophisticated argument' for trade intervention policy. According to Mun, the purpose of achieving a positive trade balance through direct intervention is to 'soberly refrain from excessive consumption'. This leads to 'greater availability of capital domestically, and so would lower cost of capital for business. It was this lower cost of capital that would promote domestic economic growth' (pp. 7–8). The chapters that follow expand the argument. However, in my view, Chapters 2 and 3 are the heavyweights of the book, where Pettis singles out three major forms of underconsumptionist intervention: financial repression, currency manipulation and wage growth.

Has China done all of these? Yes, at some point in China's 35 years of reform since 1978. But are they all relevant for the global imbalance we see today? I do not think so. On financial repression, Pettis makes a good point: China is still doing this. Interest rates are not set by the market and they are artificially low. Since depositors lack investment

alternatives, very low real interest rates contrarily attract even more domestic savings, which translates into unusually high investments. It is 'repression' in the sense that a large amount of wealth has been transferred from depositors to inefficient state sectors. However, I am not sure I agree with the author that the motive for financial repression is to lower the cost of capital and promote economic growth. The cost of capital to state firms is indeed lower than the equilibrium market rate if financial repression were absent. We must remember that most of China's economic growth over the past three decades has come not from state sectors, but from non-state sectors, where the cost of capital is actually higher due to private firms' limited access to both debt and equity markets. I tend to characterize state sectors as a vast money-wasting machine, achieving meagre returns on capital, if not destroying capital outright.

On currency manipulation, Pettis got the facts right, but not the timing, and he overestimates the importance of currency. Since 2005, the Chinese yuan has appreciated by 25–30 percent against the US dollar. Yet, during 2005–2007, US trade deficits with China not only did not decline, but they continued to soar, at a much accelerated pace. This was rather ironic for people who thought currency appreciation alone could solve the trade deficits problem. If one looks at a macro chart during this period, the rising US trade deficits timed the US housing bubble perfectly. The alternative explanation is that the Federal Reserve's super-easy monetary policy caused the housing bubble; rising housing wealth fuelled American consumption and increased trade deficits. Pettis did not consider this alternative. Instead, he simply blamed China's domestic savings–investment imbalance as being solely responsible for US trade deficits. He relies on the static gross domestic product accounting identity and declares, 'a change in the relationship between savings and investment in one country must force an obverse change in the relationship between savings and investment in another country' (p. 19). Personally, I think both China and the USA were responsible. The Chinese government, through export subsidies and currency controls, certainly aided the accumulation of US trade deficits. Nevertheless, as the old Chinese saying goes, 'one hand can't clap'. I do not think Pettis himself really believes that the Chinese were solely responsible; he just chose to present a one-sided story.

On wage growth, Pettis again got the facts right, but again got the timing wrong. Before China started state-owned enterprise reform in the 1980s, enterprise wages indeed were suppressed to support investment.

The argument would have been more relevant 20 years ago. Since then there have been tremendous changes. The manufacturing landscape is very different now and state firms produce less than one-third of gross domestic product. Wages now are mostly set by the market, and there are many private players, including foreign-invested firms. It is true that wage growth lagged labour productivity growth for many years. But was this due to government intervention? The large supply of migrant workers from the countryside has surely been a big factor in keeping wage growth in check. If the *hukou* system were to be removed, wages may face even more downward pressure. However, as the supply dwindles, wage growth is set to catch up with labour productivity growth. In fact, since 2006, labour shortages have been widely reported. In the last few years, we have witnessed the fastest wage increase across China, at over 20 percent per year.

Despite these disagreements, *The Great Rebalancing* offers a stimulating read. The author advances many arguments I find quite interesting and pushes me to rethink issues I tend to take for granted. It certainly provides a different perspective. One last thing I would like to point out is how to think about trade balances in today's globalized world. In recent decades, multinational firms have routinely moved intermediate goods to China for further processing; finished goods are then re-exported to the USA. In normal trade statistics computed on the country level, the total value of these finished goods is added to China's export totals, despite the fact that China adds only a small portion to the big pie. The new nature of the global production chain implies that China will tend to run an 'inflated' trade surplus with the USA, while it will incur large trade deficits with the countries shipping the immediate goods, such as Japan and South Korea. This raises a sober question for economists and policy makers: should we still discuss trade imbalances and conflicts based on what happens at the country level? Or, should we try a bit more digging at the firm level?

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