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Flying on one engine: the world economy today

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For the last ten years, the USA has been the main engine of global growth. Between 1995 and 2002 the United States accounted for 96 percent of the cumulative increase in world GDP. With 22 percent of world GDP, the USA is by far the largest economy on the planet.

The annual expansion of US domestic demand since the 1997 Asian financial meltdown ? even through the stock market crash and recession of 2000-2001 ? has propped up exports from Europe and Asia, breathing life into their economies as domestic demand faltered or slumped.

It is in the nature of capitalism to be in a perpetual state of disequilibrium. Capital accumulation is never a uniform, smooth process because of differences in the productivity of labour, investment patterns and trade flows. At the present time, this one-sided dependency on the USA as a market for the world?s exports has serious implications for the prospects of a global cyclical recovery.

By sucking in investment and exports from abroad, the United States has developed a large, growing and, in the medium term, unsustainable trade deficit. The benign solution would be for this imbalance to be corrected by a rise in aggregate demand in Asia and Europe. But, as we shall see, this is not easy to engineer. Instead, pressure is mounting in the USA to devalue the dollar and adopt protectionist measures against key trading partners.

Elsewhere in this journal, we show that ?globalisation? was driven by the export of huge volumes of US capital in search of higher profits than could be found at home. A return to protectionism would lead to a major reversal in this flow and, unless the role of world dynamo could be taken up by Europe or Asia, an overall decline in global production.

So what are the prospects for continued cyclical recovery in the USA? And what hope that Europe and Asia?s economies could take the strain of sustaining the world upturn by significantly expanding their domestic economies?

United States

Although the mild US recession after the stock market crash of March 2000 officially ended in November 2001 the next year saw little sign of recovery. Company profits remained flat as they struggled with excess capacity and huge debts inherited from excessive investment in the 1990s. Increased GDP depended almost exclusively on buoyant household spending.

Then, in the last three months of 2002, a cyclical recovery began. This year it has gathered some momentum as GDP rose 3.1 percent on an annual basis in the second quarter. Profits have risen by 65 percent to the summer of this year. Business investment rose in the second three months at its fastest rate since spring 2000. The question remains, however, can it continue and gain momentum or will the underlying structural weaknesses of US capitalism fatally undermine it?

The Wall St crash of 2000 ? which wiped 40 percent off shares over the next half year ? brought to an inglorious end the dot com boom and, with it, fanciful ideas of a ?new economic paradigm?. The Federal Reserve countered the recession by cutting interest rates rapidly and repeatedly, 12 times in two years, bringing them down to a 40-year low at 1 per cent.

The most immediate and durable effect of this policy was on US consumer spending. US households were hit hard by the stock market crash since a high proportion of their assets were tied up in equities. In the late 1990s, it was borrowing against these assets that allowed consumer spending to roar ahead. The crash threatened to put an abrupt halt to this but lower interest rates lessened the impact, allowing consumer spending to keep the economy afloat in the short term, even though businesses were retrenching. Naturally, low interest rates also made it possible for many US businesses to refinance their huge debts.

However, such low interest rates created a longer term problem. They allowed cash-strapped consumers to borrow time and again against the value of their homes; house prices rose steadily in these years as lower interest rates fuelled demand for mortgages. Homeowners used the cash to buy goods and to pay their credit card debts ? interest rates on home loans are half those on credit cards and are tax deductible. Today, many homeowners, mortgaged to the hilt, are dangerously vulnerable to any fall in property values.

In addition to a liberal monetary policy, the Bush administration followed a classic Keynesian counter-crisis blueprint by cutting tax and increasing federal spending. Last year, Bush announced a $1.7tn tax cuts package, the bulk of which was a give-back to shareholders and big businesses in the form of a much lower taxes on share dividends and company tax. But it also included income tax cuts and bigger child tax credits that were released this summer, injecting a further $60bn into the economy in the third quarter, equivalent to 2 percent of GDP.

Last, but not least, as part of the ?bread and guns? economic package, the Bush team have boosted arms spending to the tune of $85bn to finance the invasion and occupation of Iraq. This has accounted for 1.75 percent of GDP growth in 2003 ? half the total.

The Bush administration?s economic packages have turned a federal budget surplus under Clinton into a $300bn deficit this year and $600bn next year. Continued growth at that rate would raise it to $1,500bn in ten years, but even sympathetic commentators believe it would be difficult to sustain beyond 2006. The cost of servicing this debt would eat up huge amounts of government revenue, forcing the world?s richest country to make harsh choices on spending, cutting deep into domestic programmes or shelving plans for new generations of military hardware.

In addition, the consumer boom has sucked in imports from the rest of the world, creating a current account deficit (difference between what USA earns and what it owes the rest of the world) equal to 5 percent of GDP ? a historic high ? and growing. As recently as 2000, the USA still ran a surplus. The more it grows, the more likely it is that interest rates would have to rise to ensure that foreign investors and governments keep lending the US money to finance this deficit. However, raising rates would make servicing the debt ever more onerous.

Hence, this summer, Washington has tried to add a third string to its macroeconomic bow: a lower dollar. At the Doha annual meeting of the IMF in September, Treasury Secretary John Snow made clear ? in an echo of the Plaza Accord in 1985 ? that the dollar should fall in value and so help ease the deficits. In short, that the EU and Japan should let their currencies float higher. This is not without its dangers since ?edging the dollar down? could easily turn into a collapse as foreigners holding dollar denominated assets offload them before they become worthless.

In the last quarter of 2003, the question is this: can the monetary and fiscal measures taken so far, plus a controlled dollar devaluation, launch the US economy into a virtuous cycle of rising productivity and profits, leading to business investment, new employment and rising exports and domestic demand? If so, a benign scenario lies ahead in which above trend growth eats up the deficits as federal tax revenues increase and exports rebound.

There are several reasons to doubt this can happen. The first set of problems centre on existing levels of debt and overcapacity. Generally speaking, the new cycle of capital spending remains muted mainly because there is so much spare capacity in industry and the service sector ? probably between 15-25 per cent. This means that output could rise by a similar proportion without any investment in new plant and equipment ? or workers. It could even be that the recent rebound in production is simply a rebuilding of stocks which are currently at a six-year low.

In any event, investment will not rise while profits remain low. At the height of the dot com boom, in the late 1990s, the profit on each unit sold by US companies was, on average, 13.5 per cent. At the depth of the recession in 2001, that margin had fallen to an historic low of 7.5 per cent. Three years of sackings and restructuring have only increased it to 8.5 per cent.

At this stage, at least, the recovery remains crucially dependent on sustaining household spending. While low interest rates have helped enormously, households ? even according to the Congressional Budget Office in Washington ? have a ?dangerously low? ratio of savings to income. Indeed, although more manageable, average household debt has risen to a post-war record level of 125 percent of annual income. However, if households did decide to save more, a significant part of the recovery would falter. This could happen for two principal reasons.

First, there is the fear of unemployment. One of the most striking features of the recovery so far is how jobless it is. Unemployment stands at 6.4 per cent, 2 percent higher than in 2001 and represents 2.5m job losses in those two years. It has been called ?the greatest contraction in private sector employment since the Great Depression? by the head of the US Employment Policy Institute. Fear of unemployment may well cause a retrenchment in household spending.

Secondly, consumer spending may be hit by a softening of house prices. Already, in many areas, house price rises have levelled off abruptly due to a glut of new house building ? itself a market response to the surge in demand for houses when mortgage costs were lowered so dramatically in 2001-2002. This is a problem because, as we have seen, releasing equity from homes by re-mortgaging has been a mainstay of consumer spending.

The likelihood, then, of the US consumer continuing to be the mainspring of the US recovery is minimal. The effects of the tax and interest rate cuts are coming to an end. What could take its place? There are two possibilities. The first is more government spending but this is unlikely because the US fiscal deficit, at 6 percent this year, is huge already.

The second is that foreigners come to the rescue and continue to lend money to the US to sustain domestic demand. Because the savings rate is so low (13 percent of GDP) a quarter of the investment in the US comes from abroad. The willingness of the private sector abroad to invest has been declining for some time. Foreign governments have plugged the gap by buying US bonds and building up their foreign currency reserves. Some 67 percent of these are now held by Asian governments. The effect so far has been to prop up the value of the dollar.

However, this, too, carries a serious risk. Rising holdings of assets abroad means that the US output has to grow strongly to meet the external claims on the US implied by those foreign holdings. If, as we have seen, households cannot drive this growth, then it implies a further rise in government spending and, therefore, in the deficit.

A devaluation of the dollar could ease this but it would boost the value of the euro and yen, damaging their exports and ensuring continued stagnation, or worse, in those economies. In addition, a falling dollar would have a negative impact on the already declining appetite of foreign businesses to invest in the USA. If the Federal Reserve increased interest rates to attract foreign investors back, then, given prevailing levels of household and corporate debt, this would curtail domestic demand and business investment even further.

The brutal fact is that the world economy can only resume significant growth, at the same time as the US unwinds its trade and fiscal deficits, if domestic demand in Europe and Japan rises well above the trend of recent years. What is the likelihood of this?

European Union

The prospects of the European Union taking over the role of locomotive in the world economy from the US are slim indeed. Its industries were hit harder in many ways by the collapse of the stock market in 2000 and are taking longer to recover. The macroeconomic policies pursued by the European Central Bank and national governments are also less reflationary than those of the USA.

Moreover, the inherent divisions within a looser union of nations make consensus and co-ordination more difficult than in the USA. Finally, to take over from US, the EU would have to become more like it in its labour and product markets and the organised European working class stands in the way of both government and business in effecting these changes.

Certainly, at this stage of the economic cycle, Europe is barely helping to sustain global capital accumulation at all. GDP in the Eurozone shrank 0.1 percent in the second quarter of 2003 after growing by the same amount in the first three months. Italy and Germany, however, contracted in both quarters and France shrank by 0.3 percent in the second quarter. French consumption fell off a cliff in August, down 2.7 percent on the month ? prompting some analysts to predict a contraction of French GDP for the whole of 2003. Meanwhile, Spain?s industrial production was up only 0.4 percent on the year to August, an unimpressive outcome from the last engine of growth left in continental Europe.

The EU is suffering from the 2000 crash in several important ways. In the second half of the 1990s, EU business investment rose sharply, from 14 percent of GDP to 23.6 percent ? more than the USA experienced. Most of this was financed by bank lending rather than through the stock markets and investment trusts and pension funds characteristic of the USA. Hence, company debt rose from 58 percent of GDP in the Eurozone, in 1996, to 72 percent in 2000.

This bigger debt burden has also been slower to shrink compared to the USA. Debt was still rising well into last year while it was already falling in the USA. Household debt levels at 80 percent of disposable income at the end of 2002 were not that much lower than those in USA. But, whereas in the USA refinancing has been swift and easy for households, this is not true for the EU whose financial markets are less fluid and competitive, meaning asset wealth cannot be tapped into for current spending in the way it has been in the USA.

On top of that, by comparison with the US, the Eurozone has been very timid and slow to use fiscal and monetary policy to prime the pump and inject demand into the recession bound economies of Europe. The Federal Reserve cut rates by 5.5 percent to 1 percent while the ECB has managed a cut of only half that so that its rates remain more than twice the Fed?s levels.

Similarly, whereas Bush has cut taxes massively and boosted federal spending, the EU has done neither to date. In the EU, the stability pact dictates that member states limit their budget deficits to 3 percent of GDP. Although this has been effectively ignored by Italy, Germany and France for the last three years as their economies stumbled along, the fact remains that no large fiscal boost is possible while the EU agrees to be constrained within these limits in ?the battle against inflation?.

Finally, the 11 percent rise in the value of the euro against the dollar over the last year has come at exactly the wrong time for businesses struggling to maintain growth through exports.

All these factors combine to ensure that Euro business is finding it more difficult to escape recession, restore profitability and boost demand.

Underlying these cyclical factors, however, lies another, deeper, reason why US capitalism performs better than the Eurozone ? productivity. Up to the mid-1990s, the EU was gradually, if slowly, closing the productivity gap with the USA. Since then, the US has pulled away again. The increase in output and profits in the US is only partly a result of the poorer class organisation of the American workers which has allowed their bosses to make them labour longer and harder for less pay. More importantly, US business has also innovated and diffused new technologies more widely and deeply than the Europeans. This has carried on through the recession so that, whereas Eurozone productivity has inched up by just 0.9 percent in the last three years, it has climbed 8 percent across the Atlantic.

This productivity performance in turn has meant a swifter return to corporate profitability in the USA and a subsequent upturn in investment, even if, to date, this has been rather muted.

In the last year, the governments of France, Germany and Italy have announced measures that represent something of a break with the recent past. Germany?s Chancellor Schröder has ? in the form of Agenda 2010 ? announced a package of measures that aims to reduce labour costs to the employers by attacking pensions and social insurance as well as imposing more labour flexibility to allow sackings to be made easier. He has also announced €18 bn euros of tax cuts that will kick in next year. The French government, too, has targeted pensions as a way of cutting the fiscal deficit and has reduced corporate taxes this year.

The IMF has advised EU governments to adopt such measures, suggesting that, if they reformed their social welfare systems and labour markets to be more like the US, output would rise by 10 percent as business investment would become more profitable. However, big class battles lie between here and there and, meanwhile, the US is forced to broaden its search for help in sustaining global capitalism?s upward curve.

Japan

Japanese capitalism experienced a massive speculative bubble in land prices in the 1980s. It all came to grief in 1989, since when land prices have collapsed by 90 per cent. Because those original prices were entered as assets on bank and company balance sheets, the crash should, in theory, have been followed by a wave of bankruptcies as weaker companies, and the banks that had lent to them, went to the wall. Again, in theory, the fitter and leaner elements should have picked up the pieces, cheaply, and gone on to revive the economy. That simply did not happen.

The banks did not close and the government kept underwriting their losses, fearing the end of the consensual, patriarchal model of capitalism that has been post-war Japan. Banks have refused to lend or borrow much for investment, preferring to write down their non-performing loans gradually, and companies have not wanted to borrow, instead relying on state aid. The consumers preferred to save, fearing for the future.

Instead of private investment and consumer spending driving the economy, successive governments injected huge amounts of money into trying to kick start the economy ? mainly in the form of massive building programmes. This did briefly increase domestic demand but its effect soon faded.

In addition, the Bank of Japan, after a long delay, pushed interest rates ever lower to ease the debt burden of the stricken companies; in real terms, rates have been negative for some time. This, however, has had the effect of introducing deflation into Japan. There is so much oversupply that price competition is acute; consumers postpone spending, believing goods and services may be even cheaper tomorrow. As a result, a vicious circle has set in: output is stagnant but the real value of debt is rising so consumers and businesses do not spend so there is no stimulus to production. Growth has averaged just 1 percent a year since 1992.

Unless and until the government enforces the law of the market against the biggest banking and corporate failures it is left with only one policy to try to defend the economy. In 2003, alone, it spent $80bn on dollar assets to keep the yen low, thereby, supporting the export sector. This reliance on exchange rate policy may be like playing golf with one club but, in the absence of any other clubs, the Japanese government is not going to throw it away. That, however, is just what Washington?s demands on Tokyo amount to when they propose revaluation of the yen to help ease US deficits and restore some equilibrium to the world economy.

Such a policy would be likely to force Japanese industry and banks into the restructuring they have avoided for so long. However, in the short to medium term, it would do nothing to raise aggregate global demand as it would certainly push Japanese capitalism back into recession.

In short, neither Japan nor the EU are likely to come to the rescue of world capitalism and relieve the USA of the burden of sustaining a cyclical recovery over the short to medium term. Some commentators, however, have suggested that help could come from an entirely new quarter, the massive and growing economy of China.

China

China certainly has the world?s most dynamic capitalist economy. With most of the world in the doldrums or experiencing a fragile recovery, industrial output shot up 17 percent in the 12 months to June 2003 and exports surged by 32 per cent. Chinese exports have doubled in the last five years. Last year more goods were exported from Guangdong province than during the entire 22 years from 1978-2000. If the figures are to be believed, this economic performance outstrips Britain in the 1840s or Germany and Japan in the 1960s and 1970s respectively.

The booming cities of China?s Pearl River delta ? an area the size of Belgium ? are the workshop of the capitalist world. In 2003, the region plays the same role as Manchester played in 1843 where, as Engels put it ?the modern art of manufacture reached its perfection?. However, where Manchester was based very largely on domestic capital, Guangdong?s economy has a huge component of foreign investment. Microsoft, BP, Honda and General Electric have some of their most modern and technologically sophisticated plants in the delta and, in all, some 23,000 Japanese companies operate in China.

The statistics that describe Guangdong?s economy give a breathtaking impression of its scale: forty percent of the world?s microwaves are made in one factory in Shunde; another factory in the city, Midea, is the world?s biggest maker of air conditioners; Shenzen special economic zone makes 70 percent of the world?s photocopiers; in Dongguan there is a single factory employing 80,000 workers, mainly women, producing 100 million trainers a year for Nike, Adidas, Reebok and the rest; the centre of the world?s lighting industry is in Zhongshan and the region as a whole monopolises the world?s supply of computer game consoles and golf clubs.

Not surprisingly, China now eats up more steel and copper than the USA, an economy eight times larger, and Shenzhen?s container port is now bigger than Los Angeles and Rotterdam.

Each month, $1bn worth of investment flows into this region and $10bn worth of exports flow out. Each day, thousands arrive from the vast interior to add to the 30 million industrial workers who toil for the world?s lowest wages. Dongguan?s female footwear workers earn 36 cents per hour for up to 70 hours a week before collapsing into factory dormitories where a strict curfew is enforced.

The 1990s drift of multinational companies to China has become a rush in the new millennium. Between 1994 and 2003, China?s exports tripled from US$121 billion to $365.4 billion. Significantly, ?foreign-invested enterprises? (FIE) that is, Chinese subsidiaries of global multinationals and joint ventures with foreign partners, have accounted for fully 65 percent of the cumulative increase in Chinese exports over that period.

The seemingly inexhaustible supply of new labour keeps wage costs low and prices rock bottom. Where mass production is concerned, no one can compete with China?s new capitalist enterprises. Labour costs in Malaysia are 30 percent higher. Hence FDI to other countries in the region is falling; in South Korea by 63 percent last year and 35 percent in Indonesia.

And it is not only East Asian countries that have been affected. Mexico, for example, has been badly hit. Last year, China leapt ahead of Mexico as the world?s second biggest exporter to the USA after Japan. The consequence? More than 500 maquiladora (assembly plants) have upped and left Mexico in the last two years, stripping out 200,000 jobs in the process. And most of these ? in toys and clothing, for example, have set up in China.

Yet all is not well with Chinese capitalism. The extraordinary growth rates have led, as they have in other booms at other times, to an over investment in productive capacity. According to the People?s Bank of China, 86 percent of manufactured products are in oversupply. In 2002, Midea only sold about 60 percent of the air conditioners destined for sale in China. It is unlikely, however, that this will lead in the short term to widespread bankruptcies and closures.

On the contrary, it is entirely likely that Midea, and other firms like it, will be able to continue borrowing money from the banks, despite their poor sales. They may even be able to borrow enough to fund further expansion of capacity. The reason for this is that China?s banks combine characteristics drawn from their own involvement in the feverish ?frontier capitalism? of the last decade, from their origins in the bureaucratically planned economy and from the banking systems of advanced imperialisms, particularly Japan.

Recent experience has been that increasing capacity and raising productivity while keeping wages low guarantees an increase in market share and, therefore, continued growth. Given that the banks as institutions have a long history of providing finance to enterprises in order to meet planned growth targets, no great cultural shift is required to continue the pattern in what is now a booming economy.

In addition, the Chinese Communist Party intervenes directly when a company is threatened by failure because it fears above all else social instability and industrial unrest. China?s rulers are mindful of the need to find jobs for the rural migrants and for those being laid off from defunct state-owned enterprises. Nonetheless, part of the terms of accession to the World Trade Organisation was a requirement that Chinese banks adopt international standards of accounting and for credit control which, if implemented, would seriously limit the use of ?soft loans?.

Developments in China have had destabilising consequences for the world economy. In particular, they have made China a major source of deflationary pressure. The saturation of the domestic market has already led to savage price competition. For example, the price of a microwave oven has fallen from $240 in 1998 to $60 today, a 29-inch colour television from China?s biggest manufacturer has fallen from $800 in 1997 to $250 now. Since 1998, factory gate prices have fallen by 5 percent in four out of five years.

This in turn leads to a huge growth in exports. Midea?s exports rose by 70 percent last year and they aim for 90 percent growth this year. The country?s trade surplus expands along with the export surge. The USA?s trade deficit with China reached a record $83bn last year and is likely to exceed $100 in 2003.

This trend is given a further boost by the movement in exchange rates. Since the yuan is pegged to the US dollar, and the latter has fallen 10 percent this year against the yen and euro, China?s exports have become even more competitive in the EU and Japan.

On the back of this ? and with an election on the horizon ? a wave of protectionist sentiment is rising in the USA. Employment in US manufacturing has suddenly declined in the past three years to 14.7 million jobs after fluctuating between 17 and 18 million for 15 years. This is why there are calls for import quotas or high tariffs on selected products. Legislation has been introduced in both the Senate and the House of Representatives that would slap high punitive tariffs on China.

Since China?s massive surge in output has very largely been a result of foreign investment, including from the US, such a campaign against China is sheer hypocrisy. The threat to the US domestic economy is real enough, but it is the inevitable consequence of ?globalisation? and illustrates perfectly the contradictions of contemporary capitalism.

In fact, China?s overall trade surplus was modest, despite its trade with the US. With regard to the rest of Asia, China has a trade deficit of some $60 billion as China sucks in capital imports. The deficit with Taiwan alone is $30 billion.

Despite this reality the US has and will continue to press China to revalue its currency which has been stable against the dollar for 13 years. But China?s rulers will resist Washington?s pleadings for the same reason they refuse to close down bankrupt factories ? they need to ensure year on year economic growth to ensure social stability. Deutsche Bank estimates that with unemployment in China?s cities probably between 8 and 10 per cent, ?China has to maintain 15 to 20 percent export growth per year to be in a position not to increase the urban unemployment rate a lot.?

China has to create 10 million urban jobs each year just to absorb all the rural migrants, an additional 6-8 million jobs per year to cope with the exodus from the closing state-owned enterprises, and a further 2 million for the young people entering the workforce.

Beijing is not about to choke off its country?s exports and import inflation and social unrest into China just to please George Bush. However, the world market cannot absorb a continuously growing volume of Chinese goods forever. Even a levelling off of export volumes, let alone an absolute decline, would have serious repercussions within China and raise the prospect of the first major recession since the restoration of capitalism.

End of globalisation?

Given the very great unevenness in the global economy and the difficulty of bringing greater equilibrium and hence sustained growth to it, the most likely response of the main imperialist powers, and there are clear signs of this already, will be the adoption of protectionist measures. These can be expected to take the form of regional and bilateral measures rather than moves towards economic autarky.

One of the most deep rooted features of globalisation in the decade or so up to 2000 was a gradual reduction of tariffs and quotas, and liberalisation of capital controls. As a result we have witnessed an unprecedented expansion of international trade and foreign investment flows.

This expansion came to a halt in 2000 since when the annual increase in international trade has slumped to 2 percent from its 12 percent average in the 1990s ? and the value of FDI flows has declined year on year, pushing globalisation into reverse. The World Trade Organisation ? despite US and EU pressure ? has suffered successive failures at Seattle and Cancún to launch a new round of trade and investment liberalisation, to force the South to open up their economies to the multinationals even further.

Angered by being snubbed by an alliance of Third World countries, Washington made clear immediately after Cancún that it and the EU will proceed with building a system of bilateral and regional free trade agreements outside the remit of the WTO. This points to the emergence of precisely the series of rival regional trading blocks that the WTO was designed to stop. Already Europe and America are at each other?s throats over GM crops, steel and bananas.

As this survey has shown, none of the major economies is in a position to play the role of the locomotive that could pull the entire global economy, now more integrated and interdependent than ever before, into sustained growth. Any retreat into protectionism would ensure a decline in global production, clear evidence that ?globalisation? far from having established a new economic paradigm, free of crises and contradictions, actually created the forces of its own disintegration.
