北京大學

Tuesday, February 17, 2009

Testimony by Michael Pettis, Professor of Finance, Peking University, before the U.S.-China Economic and Security Review Commission
China's Role in the Origins of and Response to the Global Recession

Panel IV: The Effect of the Crisis on the U.S.-China Economic Relationship

For the past ten years the global balance of payments has been dominated by the trade and investment relationship between China and the US. This relationship is now undergoing a major shift. Most large economies will be affected, and to the extent that their economic policies do not accommodate this shift, they are likely to fail, in much the same way that economic policy failed in the 1930s. The consequence for the world, and especially for China, could be terrible.

The US has an historic opportunity to assert leadership in shaping and influencing the global institutions that will dominate trade and capital flows for the foreseeable future. By ensuring ways to minimize the economic disruption to a China terrified of the potential political consequences of a worse-than-expected economy, it can ensure that Chinese concerns and priorities are embodied in these institutions and that China remains a committed member of the global system.

The process will not be easy. China's trade numbers for January, released last week, could not have been more dismal. After declining by 2.8% year on year in December, China's exports plummeted 17.5% in January. The sharp contraction in export places huge pressure on the country's manufacturing sector, and already unemployment in China is surging. Chinese import numbers are even more dismaying. After declining 21.3% in December, imports dropped a staggering 43.1% in January.

At first glance there seems to be a silver lining in the export numbers: they are not nearly as bad as those reported by other Asian countries. In December, for example, Taiwan's exports fell by 42%, South Korea's by 17%, and Japan's by 35%, capping many months of severe export contraction. Less developed Asian countries also performed in general much worse than did China. From that point of view it seems that China has increased its competitive edge over its trading rivals.

But it is precisely this relative out-performance that indicates the severity of the adjustment yet to take place. China's trade surplus for January was a mind-blowing $39.1 billion, just a smidgen under November's all-time high of $40.1 billion and edging out December's $39.0 billion for second place. In comparison, in the first half of 2008 China's average monthly trade surplus was an already-high $16.7 billion. In the second half it surged to $32.9 billion.

What does this mean? The world's consumers are experiencing a sharp contraction in demand which must be "shared out" among all of the world's producers. The decline in Chinese exports means that Chinese producers are absorbing part of that contraction, but the bigger decline in its imports means that Chinese consumers are contributing an even greater amount to the contraction in demand.

Is China a trade predator?

The net result is that non-Chinese producers must absorb more than 100% of the contraction in demand from non-Chinese consumers. That doesn't mean however that Chinese policymakers are knowingly engaging in predatory behavior. On the contrary, although they seem unable – some might say unwilling – to understand China's role in the global imbalance (much like the US failed to understand its role in 1930), they would nonetheless like nothing more than to see China increase consumption sharply. To that end they have unveiled a major fiscal stimulus package and forced banks to expand lending at a pace so rapid it will almost certainly lead to a future explosion in non-performing loans.

But it will take a long time before their efforts pay off. China's outdated development model, a banking system that has allocated capital very poorly, and its weak consumer base make it very difficult for China's fiscal stimulus to cause a rapid net increase in consumption.

Take the expansion in lending. The Chinese banking system over the past decade has been in some sense the mirror image of that of the US. Whereas American banks accommodated the massive expansion of liquidity of the past decade, whose roots are discussed later in this paper, by making imprudent and foolish loans to the consumer sector, Chinese banks responded to their own surge in liquidity by channeling equally foolish lending into overinvestment.

As part of the US adjustment to the imbalance of the past decade US banks are cutting off consumer lending as they contract, but Chinese banks are actually increasing their lending into the manufacturing and infrastructure sector. Many commentators hail this ability to force countercyclical lending as a good thing, and a huge policy advantage China has over the US, Europe and other economies with independent banking systems. But this may be a very mistaken view. Although the employment effect of this lending will naturally contribute to global demand if it takes workers off the unemployment line, the consequent increase in production may easily overwhelm it, so that China will continue to export huge amounts of overcapacity into a world struggling with collapsing demand.

This can easily lead to trade war. Already Asian countries from India to Indonesia are fending off Chinese exports and western economies from France to the US are veering towards protection. But trade war would be a far greater disaster for China than most realize. Many American policymakers – and, it seems, significant parts of Chinese policymaking establishment – do not fully appreciate the impact of the global crisis on Chinese economic prospects. Although official estimates put urban unemployment in China at just over 4% of the workforce, most unofficial estimates are much higher – closer to 8% – and nearly everyone agrees that the figure is set to rise significantly in the next few months. Some credible estimates suggest that even if China were able to achieve the 7.5% growth projected in 2009 by the World Bank, unemployment would nonetheless double before the end of the year.

Things will get worse. China's huge overcapacity problem has total production exceeding consumption by around 10% of GDP. In the past China has been able to export this excess, but with export markets in the US, Europe and elsewhere contracting so rapidly, it will be all but impossible for rising domestic demand to plug the gap. Trade war would make the problem much, much worse. In addition, collapsing corporate profits will put a sharp dent in new investment, nearly two-thirds of which has been funded, in the past, out of retained earnings. Exports and investment have been two of the biggest sources of Chinese growth, and the outlook for both is pretty poor.

China needs to achieve two major objectives. Domestically it needs to increase employment. Globally it needs to reduce the amount of overcapacity it is exporting into a world struggling with collapsing demand. But these two goals are at loggerheads in the short run. Within China policymakers have so far been unable – some would say unwilling – to recognize China's role in the global imbalance. Policymakers who see the crisis as part of a necessary transition towards a more consumer-led economy are ferociously opposed by policymakers who want to combat unemployment by accelerating the existing, and deeply flawed, development model. They seek to maintain an undervalued currency, repress wages, and shift credit and resources to manufacturers and other producers of additional capacity. All of this has the effect of increasing production and repressing consumption in a world which has too much of the former and not enough of the latter.

The US can help China, and the reformers within China. Rather than demand that China immediately reduce its rising export of overcapacity, the US should work with China to achieve a manageable balance over a four to five year period. Even this will be difficult for China, but it would be much better than a catastrophic adjustment. Threatening China with trade sanctions if it does not rapidly reduce the rising overcapacity it is forcing onto the rest of the world will not work. There is very little Chinese policymakers can do in the short run without causing a collapse in the export sector and a rise in unemployment so rapid that it could quickly lead to social instability.

The world must recognize that China can adjust, but it cannot adjust immediately. It will take several years to do so, and will require significant changes in both its financial system and in its development model. To that end major economies need to work out a plan, in which China is given a reasonable amount of time to make what will inevitably be a difficult transition. In exchange, Europe and other major markets must assure open markets to Chinese exports

The world, under US leadership, has a tremendous opportunity to help China through a difficult adjustment and, in so doing, create a favorable institutional framework that will govern trade and capital relations for decades to come. If not, the advantages trade deficit countries receive from pushing the full burden of adjustment onto trade surplus counties will be overwhelmed by a global environment of deep mistrust and hostility. This is not the time to attack China. China has a serious overcapacity problem that can best be worked out in global cooperation over four to five years. To demand a quick resolution will bring more problems than relief.

The roots of the global imbalance

China runs a massive trade surplus with the US and, in recycling this surplus, a correspondingly large capital account deficit. This recycling has been the main source of the global liquidity that has engulfed the world recently as well as a constraining factor in the global balance of payments. It is impossible for either country to adjust any part of the balance without a major counterbalancing adjustment from the other, but it is far from clear that policy-makers on either side, especially in China, have a clear grasp of the issue.

Other countries have played a role in this imbalance, of course, but with a few important exceptions (OPEC, for example) they have fallen broadly into two camps whose characteristics are typified either by China or the US. One set of countries, like the US, has had booming domestic consumption and high and rising trade deficits. Their highly sophisticated financial systems intermediated the surge in underlying liquidity into the consumer loans that permitted the consumption binge. The second set of countries, like China, have excessively high savings and domestic investment rates, resulting in a huge and rising surplus of production over consumption, the balance of which is exported abroad.

Until recently excess US demand and excess Chinese supply were in a temporarily stable balance. As part of running a trade surplus, China necessarily accumulated dollars, which had to be exported to (invested in) the US. This capital export did not occur in the form of private investment – indeed it was exacerbated by Chinese net imports of private capital – but rather as forced accumulation of foreign currency reserves, which were recycled back to the US largely in the form of purchases of US Treasuries and other US dollar assets by China's central bank, the People's Bank of China (PBoC). Since China had effectively pegged its currency, the PBoC had no choice but to accumulate reserves in this manner.

The recycling process also functioned as a great liquidity generator for the world, converting US consumption into Chinese savings, which were then recycled back into the US financial markets through PBoC purchases of highly liquid US securities. There are several self-reinforcing aspects to this system that pushed it to the extremes it ultimately took. In the US the torrent of inward-bound liquidity boosted real estate and stock market prices. As they surged, substantially raising the wealth of US households, these became increasingly willing to divert a rising share of their income to consumption. At the same time rising liquidity always forces financial institutions to adjust their balance sheets to accommodate money growth, and the most common way is to increase outstanding loans. With banks eager to lend, and households eager to monetize their assets in order to fund consumption, it was only a question of time before household borrowing ballooned.

Meanwhile in China, as foreign currency poured into the country via its trade surplus, the PBoC had to create local money with which to purchase the inflow. In China most new money creation ends up in banks, and banks primarily fund investment (consumer lending is a negligible part of bank lending). With investment surging, industrial production grew faster than consumption. A country's trade surplus is the gap between its production and its consumption, and as this gap grew, so did China's trade surplus, which resulted in even more foreign currency pouring into the country, thus reinforcing the cycle.

In this balance, sometimes dubbed Bretton Woods II, Chinese overcapacity was matched with American over-consumption, and Chinese official lending was matched with US household borrowing. This ensured that the current account flows were matched with the capital account flows. Of course any change in one of these accounts required equal and opposite changes elsewhere. This is a fundamental requirement of the global balance of payments – it must balance.

The great imbalance

Many analysts think of the US economy as the engine that drives the rest of the world, but this is not always true. Sometimes changes or distortions in one part of the world can force adjustments elsewhere, and as the world's

largest and most open economy, with an astonishingly flexible financial system, it is often the US that absorbs adjustments originating elsewhere.

We see this most obviously in US trade figures. For most of last 60 years, with two exceptions, the US current account surplus or deficit has been within 1% of GDP. The first exception occurred in the mid-1980s when the deficit rose to nearly 3.5% of GDP in 1986-87 before declining sharply and running into a small surplus in 1990. The second began in 1994, around the time of the Mexican crisis, when the US current account deficit climbed to around 1.6% of GDP, declined for two years, and then took off in 1997-98, after which time it raced forward in straight line to peak at around 6% of GDP.

If the US trade deficit were driven simply by a US consumption binge, as is often claimed, it is hard to see why it would have followed a pattern of general stability over many decades marked by two surges – a small one from 1984-1988 and a very large one after 1997. If it was driven by changes in Asian savings and trade policies, this pattern becomes easier to understand. The 1980s surge was driven largely by domestic Japanese policies and conditions and is a fascinating case study in itself, but it is the post-1997 surge that is much more interesting and relevant to the current crisis.

1997 was, of course, the year in which several Asian countries experienced terrifying financial crises and viciously sharp economic contractions, profoundly impressing Asian policy-makers to this day. One of the main lessons policy-makers learned from the crisis was that too much dollar debt and not enough dollar reserves put a country at serious risk of a balance-sheet crisis. To protect themselves from a repeat of the disastrous 1997 crisis many Asian policymakers engineered trade surpluses and began amassing large foreign currency reserves by managing trade policy and the value of their currencies.

This resulted in what some have called a global capital flow "paradox" – the fact that in recent years developing countries have been large and growing net exporters of capital to rich countries. This is a paradox because, historically, capital-poor developing countries have generally been net importers of capital. Accumulating foreign currency reserves involves exporting capital, but for most of the last fifty years official capital exports, in the form of foreign currency reserve accumulation, were significantly less than net private capital imports.

In 1998 official capital exports among developing countries began to take off, and by 1999 exceeded net private capital imports. This is when the "paradox" begins. Since 1998 except for a small decline in 2001 net capital exports from developing countries surged almost in a straight line to around $700 billion annually (combining $1.2 trillion of reserve accumulation versus $0.5 trillion of net private inflows).

But the global balance of payments must balance. As Asian trade surpluses and net capital exports surged, some other part of the world had to equilibrate these adjustments by running large trade deficits and importing capital. The US did exactly this, and the US trade deficit soared after 1997 while at the same time US household savings collapsed.

Rebalancing act

This process was enabled by two related factors. First, the massive recycling of the US trade deficit into the US securities markets set the stage for the surge in real estate and stock market prices which, by raising the market value of accumulated US savings, encouraged households to consume increasingly larger shares of their income.

Second, as financial institutions accommodated themselves to the surging liquidity, their response – as it has always been during every liquidity surge – was to expand credit rapidly. This included new lending to home-owners and consumers. As banks made nearly unconditional lending offers to American consumers, inevitably debt-financed consumption rose. US households took advantage of laughably easy lending conditions to engage, much too willingly, in the greatest, gaudiest spending spree in history.

Now, however, the party is over. The old balance of payments has finally broken down, and the world is lurching drunkenly to find a stable new balance. One necessary consequence of the financial crisis must be an increase in US household savings rates. Collapsing real estate and stock markets have caused household wealth to decline sharply, and households must save more than ever out of current income to replenish their wealth. But even if consumers wanted to continue spending, American commercial banks – caught in one of the worst credit crunches in recent history – are no longer willing to lend for consumption. The US household savings rate has nowhere to go but up.

By how much will US household savings increase? For most of the past sixty years until the early 1990s US household savings rates have varied between 6% and 10% of GDP, except for a brief period during the economic crisis of the 1970s when household savings went as high as 13% of GDP. In the early 1990s, the savings rate began declining slowly, and then virtually collapsed after 1997 when household savings fell to well under 2% of GDP.

Although we can't say for sure, it is probably safe to argue that US savings rates will climb back at least to earlier average levels, or even temporarily exceed those levels, as American households rebuild their shattered balance sheets. If they return only to 8%, the mid-point of earlier savings rates, this implies that US household savings must rise by some amount equal to 6% of US GDP, or, to put it another way, that all other things being equal, US household consumption must decline by at least that amount.

But since the balance of payments must balance, something must happen to equilibrate this decline in US household consumption. Either consumption in other sectors of the US economy – i.e. the government, since businesses are also contracting – must expand by that amount, or consumption by foreign countries, with China bearing the brunt, must expand by that amount (and foreign savings decline). To the extent that neither happens, global overproduction – which consists mainly of Chinese overproduction – must decline by that amount. This is just a way of saying that if net American consumption declines, either consumption must rise somewhere else, or production must fall.

In the best possible world Chinese consumption would rise by exactly the same amount as US consumption drops, and we would quickly reach a new stable balance, with one major difference: the US trade deficit would decline, and the amount of capital exported by China to the US would decline by exactly the same amount (the PBoC would accumulate fewer reserves). But if that doesn't happen, total global consumption must decline, and the world economy slow – in fact as it slows global income will decline with it, so that both savings and consumption could decline, trapping the world in a downward spiral of unstable adjustment.

By how much must Chinese consumption rise to prevent a global slowdown? Given that the US economy is about 3.3 times the size of China's, and consumption accounts for less than 50% of China's income, Chinese consumption will have to rise by nearly 40% (or roughly 19% of China's GDP) in order to accommodate an

increase in US savings equal to 6% of US GDP. This is clearly unlikely. Of course there is more to the world than simply US household demand and Chinese government demand. There are several other factors that will affect the adjustment. Among the positive ones:

- US fiscal expansion will absorb some of the decline in US household demand.
- The Chinese trade surplus has been equal to about one-half to two-thirds of the US trade deficit, so in principle China should only absorb that share of the global adjustment, while other surplus countries, especially OPEC via lower commodity prices, absorb the balance.

Among the negative factors:

- Assuming a 6% increase in US household savings, to 8% of GDP, is probably conservative. Goldman Sachs predicts that household savings will rise to 10% of GDP.
- It is not just US households and the government that matter. US businesses affect demand too, and they are likely to contract, thereby increasing the total contraction in US demand.
- The world's major economies – Europe, and Japan – as well as many of the smaller economies – Latin America, Russia and Eastern Europe – are more likely to exacerbate global demand contraction, with several of them facing capital outflows (and hence a reversal of their trade deficits into surpluses, which adds to global overcapacity).

It's 1929 again

Although there are great differences between 1929 and 2008 that should not be papered over, the global payments imbalances that led up to the current crisis were nonetheless similar in many ways to the imbalances of the 1920s – with a few countries, dominated by one very large one, running massive current account surpluses and accumulating, in the process, rapidly growing central bank reserves. In the 1920s it was the US that played the role that China is playing today. The U.S. economy had been plagued in the 1920s with overcapacity caused by substantial increases in US labor productivity. This was a consequence of significant investment in the agricultural and industrial sectors and mass migration from the countryside to the city.

Although US capacity surged in the 1920s, domestic demand did not rise nearly as quickly. As a consequence the US ran large annual trade surpluses ranging from 1% to 3% of US GDP during the decade of the 1920s, or 0.4% of global GDP (China, although only 6% of world GDP, has run trade surpluses of roughly the same magnitude). These trade surpluses stayed high as long as domestic production grew more rapidly than domestic consumption. US overcapacity didn't matter when there was sufficient foreign demand. It could be exported, mostly to Europe, while foreign bond issues floated by foreign countries in New York permitted deficit countries to finance their net purchases.

But as the US continued investing in and increasing capacity, without increasing domestic demand quickly enough, it was inevitable that something eventually had to adjust. The financial crisis of 1929-31 was part of that adjustment process. When bond markets collapsed as part of the crash, bonds issued by foreign borrowers were among those that fell the most. This, of course, made it impossible for most foreign borrowers to continue raising money, and by effectively cutting off funding for the trade-deficit countries, it eliminated their ability to absorb excess US capacity.

The drop in foreign demand required a countervailing US adjustment. Either the US had to increase domestic consumption, or it had to cut back domestic production, but there was unfortunately more to the crisis than simply the drop in foreign demand. With the collapse of parts of the domestic US banking system, domestic private consumption also fell. The slack in demand should have been taken up by US fiscal expansion, but instead of expanding aggressively, as John Maynard Keynes demanded, President Roosevelt expanded cautiously. When the credit crunch came and the world was awash in American-made goods that no one was willing or able to buy, it was unreasonable, as Keynes argued bitterly, to expect the rest of the world to continue purchasing US goods, especially since the financing of their consumption had been interrupted.

Since US production exceeded US consumption, the need for demand creation, according to Keynes, most logically resided in the US. But the US had other ideas. In 1927 and 1928 there had already been unemployment pressures in the US, and the 1929 collapse in foreign and domestic demand exacerbated those pressures. This prompted US senators to respond in 1930 with the notorious Smoot-Hawley Tariff Act aimed at boosting demand for domestic production. They attempted, in other words, to create additional demand by diverting demand for foreign goods to US goods – basically attempting to export their overcapacity – and in so doing force the brunt of the adjustment onto their trading partners. Their trading partners, not surprisingly, retaliated by closing their own borders to trade, causing international trade to decline by nearly 70% in three years, thereby shifting the brunt of the adjustment back onto the US.

Without global trade each country had to adjust domestic supply to domestic demand. For countries with excess demand, this meant expanding production, whereas for countries with overcapacity, that could mean slashing production. There is an important lesson in here for us. In an overcapacity crisis, trade-surplus countries are likely to be more vulnerable to trade war than trade-deficit countries, because trade war implies an expansion of production in the latter and a contraction in the former. In the 1930s it was noteworthy that the trade-surplus countries suffered more deeply from the crisis than did trade-deficit countries once barriers to trade were imposed.

What would Keynes say?

The trade tariff made things worse not just because impediments to trade are costly to the global economy but rather because it set off a trade war in which other countries forced the US broadly into balance. In two years US merchandise exports declined 53% to $2.5 billion in 1931, while the trade surplus declined by 63% to under $400 million (US GDP was about $76 billion). US excess production over consumption had to be resolved largely within the US, and since much domestic investment had been aimed at the export sector, the collapse in exports brought a concomitant decline in domestic investment. That meant that either the US engineer a substantial increase in domestic demand by fiscal means, as Keynes demanded, or that it adjust via a drop in production and employment. It did the latter.

China today may be facing a similar problem. Today it is China who is exporting overcapacity and it is the US who is consuming too much, fed by Chinese financing. With the collapse of bank intermediation US households and businesses are cutting consumption and raising savings. This is a necessary adjustment. Most analysts, perhaps thinking they are echoing Keynes' analysis of the problem in the 1930s, call on the US government to engage in massive fiscal expansion to replace lost private demand. But this is not what Keynes would have recommended. If declining US private consumption is met with increasing public consumption, the world will simply continue playing the game that has already led into so much trouble. The only difference would be that instead of having one side of the global imbalance accommodated by *private* US over-consumption

and rising debt, it would be accommodated by *public* US over-consumption and rising debt.

But like in the 1930s, if there is a drop in global demand, it is countries with too little demand, the trade-surplus countries, who will need to adjust more than countries with too much demand. Because of the importance of the export sector to domestic growth and employment, and because of the strong positive correlation between exports and domestic investment, if their exports drop quickly there may be significant political pressure for these countries to engineer moves to expand exports.

However since most of them lack large domestic markets, the result isn't likely to be direct import tariffs. What we are more likely to see is direct and indirect export subsidies and competitive devaluations. Already in Asian trade-surplus countries policy-makers are raising export rebates, providing cheaper financing to suffering exporters, restraining wage increases, and even engineering currency depreciation, all to strengthen their share of the declining export market, and all of this is happening even before the real impact of the global slowdown begins to appear.

If Keynes were around today he would probably make the same point he did over 70 years ago. Demand must be created by the trade-surplus countries who have, to date, relied on net exports to protect themselves from their overcapacity. They must force demand up quickly in order to close the gap, and since expecting private consumption to rise quickly enough is unrealistic, it has to be public consumption – a large fiscal deficit.

Smoot-Hawley with Chinese characteristics

But above all they should not try to grow their way out of overcapacity problem by reducing imports or increasing exports. Nor, amounting to the same thing, should they constrain consumption or boost production – by reducing interest rates, constraining wage increases, forcing corporate credit growth, or otherwise subsidizing producers. In 1930 the US foolishly tried to dump capacity abroad by creating import restrictions (which have the effect of expanding domestic production), but the furious, and hardly surprising, reaction of its trading partners caused the strategy to misfire and the US suddenly found itself forced to bear almost all of the adjustment on its own.

Might China and smaller Asian countries repeat the US mistake? Perhaps. China already seems to be in the process of engineering its own efforts to defend its ability to export overcapacity. Although there has been an attempt to boost fiscal spending, most analysts argue that this so far has been too feeble to matter much. On the other hand it has tried to protect and strengthen its export sector by lowering export taxes and reducing interest costs, which lower the financing cost for producers and have little impact on consumers.

This cannot work for long. The world clearly suffers from overcapacity, and as the US reduces demand and increases savings, which it must do, overcapacity will only rise. The proper place for new demand to originate is, as in the 1930s, in trade-surplus countries. They should be engaged in expanding demand, not expanding supply. If they try to export their way out of a slowdown, there will almost certainly be a trade backlash, as there was in the 1930s, in which case the full force of the adjustment will be borne by the trade-surplus countries, again as in the 1930s with the proviso that although China's trade surplus as a share of global GDP is comparable to the US trade surplus in the 1920s, China is a much smaller country, and so its trade surplus represents a much higher share of China's GDP.

The trade-deficit countries know that surplus countries must absorb most of the overcapacity adjustment, and as the world's economy contracts, their domestic tolerance for rising Asian trade surpluses, or even just a continuation of current trade surpluses, is likely to decline. In order to avoid trade friction the world's major economies must engineer a joint program of fiscal expansion, in which the trade-deficit countries expand moderately so as to slow down the adjustment period and to give maximum traction to fiscal expansion on the part of the trade-surplus countries.

But it is the surplus countries that must inevitably bear most of the burden for demand creation. Fiscal expansion on the part of the trade-deficit countries should occur with the clear understanding that it is a temporary measure aimed only at assisting the transition away from an over-reliance on exports to absorb capacity. The world will not support indefinitely continued debt-fueled overconsumption on the part of the US, whether this consumption takes place at the private or public level, and it cannot support continued growth in Chinese capacity without more rapid growth in Chinese consumption. To continue in this way almost certainly means little more than to postpone a larger and more difficult adjustment on the part of both countries, and will probably eventually lead to a collapse in international trade.

Given the relatively small size of its economy and the huge relative size of its trade sector, it is almost impossible for China to absorb its share of US demand adjustment without enormous and probably unacceptable social and political costs. In order to make the transition workable, it is necessary that China be given at least three or four years during which time it makes concerted efforts to boost domestic demand to the point where global imbalances are more manageable. But US (and European) demand contraction will not occur over a three or four year periods. It is occurring much more quickly at a shockingly rapid pace.

There is a real risk that the adjustment process in China will careen out of control. In order to manage this risk, US, European, Japanese and Chinese policy-makers must quickly come to a firm understanding of how significant the global adjustment is and how dangerous the process will be for China, and design a multi-year plan of demand expansion in which China is given time to adjust its overcapacity. If major economies focus only on domestic adjustment, China will almost certainly choose the path of defending its ability to export overcapacity onto the rest of the world, while the trade deficit countries will discover the expansionary impact of trade constraints. In that case it is hard to imagine how China and the world can avoid disaster.

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Last Saved By: Kathy
Total Editing Time: 1 Minute
Last Printed On: 2/17/2009 9:51:00 AM
As of Last Complete Printing
Number of Pages: 10
Number of Words: 5,752 (approx.)
Number of Characters: 29,682 (approx.)