

WSWS International Editorial Board meeting

Report on the world economy in 2006

Part One

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Published below is the first part of a report delivered on January 22, by Nick Beams to an expanded meeting of the World Socialist Web Site International Editorial Board (IEB). Beams is a member of the WSWS IEB and National Secretary of the Socialist Equality Party (Australia), which hosted the meeting in Sydney from January 22 to 27, 2006. Part two was published on March 1 and Part three on March 2. David North's opening report to the WSWS IEB meeting was published on 27 February. Further reports will be published subsequently.

This year has opened with predictions of further strong growth in all the major industrial economies and in the global economy as a whole, following a world growth rate of 4 percent in 2005—the highest level for some time.

The president of the European Central Bank, Jean Claude Trichet, told a meeting of bankers on January 9 that global economic growth in 2006 could even exceed that of last year. Others share this view. According to Trichet, central bankers believe that “global growth is continuing at a pace that is dynamic and we don’t even exclude that global growth could be a little bit higher in 2006 in comparison with 2005.”

As if to confirm this rosy outlook, the Dow Jones industrial average went past 11,000 the following day—the first time it has reached that level since June 2001—after having gained more than 2 percent in the first four trading sessions of the New Year. The last time the Dow went past 11,000 there were predictions it could go to 36,000. Such claims are no longer made but there is, at least on the surface, the appearance of optimism.

The US economy is predicted to grow by 3.4 percent in the coming year, the eurozone by 1.9 percent, Japan by 2.0 percent, and the United Kingdom by 2.1 percent. China, having announced a 10 percent growth rate for 2005, is expected to expand by at least 8-9 percent in the coming year. Corporate profitability is also set to rise, with predictions of the profit increase for the S&P 500 at 13 percent.

However, behind the short-term optimistic outlook, serious economists have concerns about the state of the global economy. They point to a series of deep-going structural imbalances and tensions—above all generated by the mounting US balance of payments deficit and accelerating indebtedness—which, at a certain point, must give rise to rapid changes, if not a crisis. These concerns were reflected in a number of comments published as the year opened.

Adam Posen, an economist with the Institute for International Economics, in an article entitled “Batten down the hatches in case the storm hits,” drew an analogy with Hurricane Katrina, and warned of the “potential economic storm that will be generated by the inevitable adjustment of global imbalances.”

“No one could have prevented Katrina, but the damage from it could have been significantly reduced. Similarly, there are policy steps that

should be taken to batten down the global economy ahead of a potentially severe shock from renewed trade protectionism or dollar adjustment.”

Little, however, had been done. “If the governments of the big economies wanted to learn from Katrina, though, they would take action to limit the damage that resolving the current global imbalances could bring” (*Financial Times* December 28, 2005).

While Posen did not explicitly make the point, there is a fear that if and when an economic Katrina does hit, the response of financial authorities will be on a par with that of the Bush administration when faced with the hurricane.

An article by Kenneth Rogoff, former chief economist at the International Monetary Fund (IMF), published on January 3, began as follows: “Let me first acknowledge that we are indeed living in boom times. The central scenario for 2006 is continued strong global growth. Rising global investment combined with higher demand by oil and commodity exporters should keep overall global demand growing briskly in 2006, even as US consumption and Chinese investment growth slacken.”

There were, he continued, numerous positive developments underpinning this happy scenario, including the rise of Asia, and especially China, the reduction of inflation and the decline in long-term interest rates. But this was not the end of the story.

“As good as the economic fundamentals are, it is easy to find more down-to-earth vulnerabilities. Top of the list has to be global housing prices—which are not actually that close to earth any more. With US prices up 60 percent since 2000 and even higher price inflation in many other countries it is not hard to imagine a collapse ...”

The *Economist* magazine drew a similar conclusion in a survey published on June 16, 2005, in which it described the global housing price boom as possibly “the biggest bubble in history.”

According to Rogoff: “[The] global financial system, while fundamentally a source of strength, is also a source of weakness. The explosion of unregulated hedge funds and the widespread use of derivatives such as credit default swaps pose risks that are simply impossible to calibrate until the system is stress-tested. This could come, for example, in the wake of a dollar collapse, still a considerable risk as global interest rates equalise and investors turn their attention to the US’s unsustainable trade deficit” (*Financial Times* January 3, 2006).

In a comment published the following day, *Financial Times* economics correspondent Martin Wolf noted that the fact that the dangers to world economy were not being recognised in financial markets was itself a factor in potential instability.

“For the world economy, a happy new year is now expected. But forecasters usually assume that recent trends will continue, modified where appropriate by reversion to a longer term mean. It is more useful,

however, to ask what might change. When everything is going quite well, as now, that mostly means asking what could go wrong and, more important, whether the risks of its doing so are adequately priced. The answer is: they are not.”

The sources of these concerns were clear. For the present course to continue, Wolf noted, finance had to keep flowing into the US to meet its widening balance of payments gap, interest rates had to remain low, and debtors, especially in the US, must be willing and able to go on borrowing to finance consumption spending.

There were “many risks” of disruption arising from the “imbalances” in the world economy. The financial deficit of US households, he pointed out, was running at more than 7 percent of GDP. Indebtedness of the household sector had risen from 92 percent of disposable income in the first quarter of 1998 to 126 percent in the third quarter of last year. Household debt service payments had been pushed to an all-time high of 14 percent of disposable income. “What would happen if house prices ceased to rise or interest rates increased?”

“Large dangers of disruption exist. But markets are ignoring them. So we must recognise the danger not only that something will go wrong, but that markets will then multiply the needed corrections” (*Financial Times* January 4, 2006).

In other words, when a shift does take place, the consequences will be all the more severe because the possibility of such an event was ignored in the preceding period.

And what will be the political consequences, especially in the United States, of a crack-up in the global economy resulting from the present imbalances? This question was posed in an article by *Financial Times* columnist Anatol Lieven last year. In the face of a crisis, he asked, was the present US political system capable of serious reform?

“The issue is not whether such reform can take place quickly, but whether American society is capable of talking seriously about it. The actual implementation of radical change, in the US or elsewhere, does not occur without a crisis. At present, such a crisis is being prevented by the willingness of China and Japan to buy US debt, sustain US consumer spending on their exports and allow the Bush administration to go on cutting taxes. But this situation is fragile. By radically increasing the US budget deficit and emphasising the future costs of global warming, hurricanes Katrina and Rita have underlined that fragility and helped to draw the contours of future crises.”

Lieven pointed out that the last time the US economic and political system had faced an “existential crisis” was in the Great Depression. That was overcome by Roosevelt and the New Deal. But the New Deal had been prepared by the development of a reformist political movement over the preceding 40 years. No such movement existed in the US at the present time. In fact, serious political reforms could not even be sensibly discussed. Such a situation could have major consequences.

“If a crisis on the scale of 1929-32 strikes the US now, the country would not find an FDR with a New Deal program to run against the Republican’s Herbert Hoover. It would have a timid, ineffective Hoover for the Democrats running against a Republican Calvin Coolidge, a hidebound defender of the worst aspects of the existing system. If that had been the choice in 1932, the very foundations of the American state would have been in peril” (*Financial Times* October 15, 2005).

The significance of the rapid growth of China

Let us now seek to delineate the central trends of development in the world economy because it is only on this basis that one can understand the myriad contradictory processes and tendencies at work.

Such a study must be grounded on an historical appraisal. In his famous report to the Third Congress of the Comintern (Communist—or Third—International) in 1921, Leon Trotsky began by pointing out that capitalism possessed a “dynamic equilibrium, one which is always in the process of either disruption or restoration.” The outbreak of World War I clearly marked such a break down. While there were ups and downs in the economic cycle during the 1920s, no new equilibrium was established. All the contradictions of global capitalism which had given rise to the war, festered and matured, leading first to the Great Depression and the horrific consequences it brought, and then, finally, to the eruption of World War II.

In our epoch, the period 1971-75—the collapse of the Bretton Woods monetary system and the initiation of global recession, followed by stagflation—marks the end of the post-war economic equilibrium established under the hegemony of dominant US capitalism. We are confronted with the question: has a new equilibrium been established or, on the contrary, have the contradictions which led to the breakdown of the previous economic order deepened and intensified? Is global capitalism moving towards establishing a new economic equilibrium or further away?

If we look back over the past 30 years there are two outstanding phenomena: the economic decline of the United States and the economic rise of East Asia, India and, above all, China. When President Nixon scrapped the Bretton Woods monetary system and established the US dollar as a fiat global currency—that is, world money not backed by any store of value, but by the authority of a state—the United States was still, by far, the most powerful economy in the world. It was the world’s chief source of investment funds and the leading creditor nation. That position was to continue at least until the end of the 1980s. Since then, however, the US has become the world’s biggest debtor. Global capitalism has never experienced such a situation—where the leading power is the most indebted.

While the US plunges deeper into debt—the November balance of trade figures were regarded as “good news” because the monthly trade gap fell from \$68 billion to \$64 billion—China is undergoing an explosive industrial development, the scale of which has never been seen before. These two processes, which are intimately connected, are the most dramatic expression of powerful forces at work in the very heart of the world capitalist economy.

Any serious economist is generally quick to point out that the present situation, in which the US sinks deeper into debt—with funds provided by the central banks of Japan, China and East Asia, while at the same time providing a market for the goods produced there—is inherently untenable in the long term. But it is this very unstable relationship that provides the foundation for economic growth in the world economy. According to the IMF, between 2000 and 2005, China and the US between them directly accounted for around 40 percent of world economic growth, and more than 50 percent when taking into account their demand for exports from other countries. (*Australian Financial Review* January 9, 2006)

The present economic order is dominated by what former US Treasury Secretary Lawrence Summers has called the “balance of financial terror”—the Asian central banks continue to supply funds to the US out of fear of the consequences if they do not.

As the economic commentator Clyde Prestowitz put it: “The nightmare scenario—an economic 9/11—is a sudden, massive sell-off of dollars; a world financial panic whose trigger might be as minor, relatively speaking, as the assassination of a second-rate archduke in a third-rate European city. A collapse of the dollar and its consequent abandonment as the world’s reserve currency would create a deep recession in the United States. Gas and fuel prices would soar, anything imported would suddenly become much more expensive, interest rates would jump, as would unemployment. The ‘stagflation’ of the 1970s—slow growth and high

unemployment combined with double-digit inflation and double-digit interest rates—would look like a walk in the park. And since the United States is at present the world's only major net importer, all of the exporters that depend on it for their economic stability would suffer severely as well. It's the thought of these consequences that makes the big dollar holders so nervous, and makes them, for now, hold on to their excess dollars" (Clyde Prestowitz *Three Billion Capitalists* pp. xii-xiii).

The rapid growth of China cannot be adequately covered by a series of statistics, but it does give some indication the extent of the transformation. For the past two decades, economic growth has averaged around 9 percent per year. This means that the Chinese economy doubles in size about every eight years or so. China's share of world trade over the same period has increased at least sixfold—from around 1 percent to 6 percent in 2004. It is likely to be higher today. China is now the world's second biggest exporter behind the United States, having overtaken Germany this year. From mid-2002, China became the second largest holder of US long-term debt securities after Japan. It now holds official foreign currency reserves of \$819 billion—an increase of \$209 billion over the past year—second only to Japan's holdings of \$847 billion. It is expected to hold reserves of \$1 trillion by the end of this year. (*Financial Times* January 16, 2006)

In the last 20 years, there has been a transformation in the composition of China's export trade. The share of manufactured goods has risen from 50 percent to more than 90 percent, with primary goods contracting to a share of just 9 percent.

Indeed, China has become the manufacturing centre of the world. It produces most of the world's photocopiers, shoes, toys, and microwave ovens; half of the world's DVD players, digital cameras, cement, and textiles; a third of its DVD-ROM drives and desktop computers; and a fourth of its mobile phones, TV sets, PDAs, steel and car stereos. Much of this production is exported—exports have increased eightfold to \$400 billion since 1990, and last year China shipped over 30 percent of Asia's exports of electronic goods.

Of course, when we speak of China exporting this and that, the terms we employ reflect the fact that our language has fallen behind the vast and rapid changes in world economy. It would be more accurate to speak of firms operating out of China, because the central feature of the transformation in the Chinese economy has been the setting up of factories by the inflow of foreign direct investment (FDI).

In the period 1979-82, the inflow of FDI was just \$1.77 billion. It rose to \$3.49 billion in 1990, and then began to take off, especially following the Tiananmen Square massacre of June 1989, and the subsequent assurances by Deng (in 1992) that China was committed to foreign investment and market relations. In 1991, FDI was \$4.37 billion. It more than doubled the next year to reach \$11.01 billion, and more than doubled again to reach \$27.52 billion in 1993. FDI is now running at around \$60 billion per year. China is the largest recipient of FDI, eclipsing the United States, and the total stock of foreign investment is now more than \$500 billion.

This massive investment has been driven by the efforts of major corporations to overcome the never-ending downward pressure on profit rates and cut costs. It has been estimated that going offshore to China can save a manufacturer between 20 and 50 percent of the cost of production. Labour costs in China are one fifteenth or one thirtieth of what they would be in the US or Europe. Building and equipment costs may be as much as 70 percent less.

If China has become the manufacturing centre of the world, then India is becoming the office—the centre for information technology and services. In the year 2000, Indian software exports were about \$6 billion. By the end of 2004, they were estimated to have reached \$16 billion. According to the accounting firm Deloitte, within the next five years the world's biggest financial firms will have shifted \$356 billion and 2 million jobs offshore, mostly to India. One estimate predicts that India's IT services industry will have revenues of \$57 billion and employ 4.4 million people,

and constitute 7 percent of GDP by the year 2008.

In a comment published on January 9, Morgan Stanley chief economist Stephen Roach noted that: "Just five years ago, while white collar outsourcing was confined to data processing and call centres; today, courtesy of IT-enabled connectivity, it has moved to the upper echelons of the knowledge-worker hierarchy—software programming, engineering, design, doctors, lawyers, accountants, actuaries, business consultants and financial analysts."

The industrialisation of China is having a profound impact on the economic and, therefore, political relationships of the Asian region. In a report published in 2004, the IMF noted that while China's imports from all regions had been growing, imports from the surrounding region had been growing the fastest. "This reflects China's rising role as a regional processing centre and manufacturing hub for re-exports, and suggests that its impact as a regional engine of growth could soon become even larger than Japan's."

In the decade 1991-2001, world trade increased by 177 percent. Interregional trade in East Asia, however, increased by 304 percent in the same period.

Let us take the example of South Korea, which is one of those countries increasingly drawn into the economic orbit of China. China's share of South Korea's exports has risen from 2 percent in 1990 to around 24 percent today. South Korean firms have been investing heavily in China and China accounts for about 90 percent of South Korea's trade surplus.

In 1999, South Korea did less than 10 percent of its merchandise trade with China. That figure has risen to 18 percent. In 1999, the figure for Australia was just over 5 percent. This has risen to around 12 percent. The increase for Singapore is from under 5 percent to almost 10 percent. For Malaysia the rise is from 2.5 percent to about 9 percent, and for Japan the increase is from 9 percent to 17 percent. [*Financial Times* December 9, 2005]

More than half of China's trade volume is within the East Asian region. In 2003, trade between China and the rest of Asia rose to \$495 billion, up by 36.5 percent on the previous year. This was largely as a result of increased exports from the region, up by 42.4 percent to \$272.9 billion. In 2003 alone, China's imports from Japan jumped by 38.7 percent; from South Korea by 51.7 percent; and from India by 87 percent. (See *Power Shift China and Asia's New Dynamics* David Shambaugh ed. p. 37)

The phenomenal growth of manufacturing industry in China has completely disrupted the economic relationships that developed in the East Asian region in the 1980s and early 1990s. That system was known as the "flying geese" model. Japan was the lead goose in the flock, with the other countries, including China, fanning out behind.

In the flying geese model, the East Asian economies imported capital goods from Japan, as Japanese investment moved into the region, producing manufactured goods which were then exported to the United States and other markets. This system was the foundation of the so-called "Asian economic miracle," which provided more than 50 percent of the increase in world economic growth in the early 1990s.

The Asian economic crisis of 1997-98 had a devastating impact on all the countries of the region, as well as Japan. The crisis was seized upon by the US to push through far-reaching economic and financial restructuring, something it had previously advocated, but with no success. Enjoying an inflow of capital, the Asian economies were under no pressure to change in the direction demanded by the US, which saw Japan as the beneficiary of the existing system. When the crisis erupted, the battle cry of the US was to end "crony capitalism"—with Federal Reserve chief Greenspan explaining that this was just another example of how any sort of regulation was doomed to failure.

The real issue was not "crony capitalism" but the position of Japan. This was well recognised in Tokyo and, when the crisis broke, the Japanese government proposed advancing a \$100 billion rescue fund for the region.

The result was a head-on clash with the United States, which insisted that the IMF—that is, US banks and financial institutions—had to play the central role.

Faced with a major confrontation with the US, Japan withdrew its proposal, and restructuring proceeded under the dictates of the IMF. No doubt one of the factors that influenced Japan was the fact that its proposals received no support from China.

In the wake of the Asian crisis, we have seen the end of the flying geese model, and the accelerated industrialisation of China. This is one of the central factors behind increasing tensions in the recent period between Japan and China. Japan's post-war economic domination of the region is being called into question by the rise of a new power on the Asian land mass, rather in the same way that the balance of power relationships which Great Britain had striven to maintain on the European continent were disrupted by the industrialisation of Germany in the latter part of the nineteenth century and the early years of the twentieth.

Spectacular as the growth of the Chinese economy has been, it is marked by profound contradictions. At the centre of the growth dynamic has been the expansion of exports. Between 1980 and 2005 exports increased 41 times, expanding at a rate of 16 percent per annum. But such a growth rate cannot be sustained. Were it to continue for another decade, China's exports would be greater than the combined exports of the US, Japan and Europe.

Export growth at the same rate as the past is clearly not possible. However, if it does not continue, then unemployment—and the resultant threat to the social order—will rapidly escalate. It is estimated that surplus labour in agriculture could be as much as 150 million and more, and the opening up of Chinese agriculture to competition from the world market, following China's entry into the World Trade Organisation, means that global economic forces will drive this surplus population towards the cities. At the same time, the regime itself is closing down state-owned enterprises—with 14 million jobs cut from them in the last five years.

When confronted with these contradictions, conventional economic wisdom insists that the way forward for the Chinese economy lies in the expansion of its domestic market, where consumption spending is less than 50 percent of GDP, as compared to the United States where it is running at more than 70 percent. But any significant expansion of domestic demand would require an improvement in the living standards and wages of the working masses. This, in turn, would bring about an increase in labour costs—already starting to rise—cutting away at the very advantage China enjoys as the preferred site for investment capital.

The success of Chinese industrialisation has been predicated on the pressure applied to wages due to the creation of a vast industrial reserve army, comprised of peasants who have moved in from the countryside. At the same time, the export-led industrialisation process will not be able to continue at the same rate as before. In other words, the industrialisation of China, far from creating the conditions for a new economic equilibrium, is wracked by deep-going contradictions that have the potential to create violent eruptions in the class struggle.

To be continued.



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