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Looking beyond Current Account Imbalances: Imperatives for The United States

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Abstract

The growing trade disparity between the world's two largest economies, the United States and China, is often seen as the genesis of the current global imbalance, which exploded in 2007 with the onset of the financial crisis in the United States and the resultant worldwide economic recession. In other words, the crisis was caused by three interlinked factors – high liquidity (in turn, catalysed by imbalances in payments), high leverage and regulatory oversight.

Many solutions for unwinding the global imbalance have been proposed, requiring nations to moderate production and consumption imbalances and calling for financial sector regulations and reforms. However, the issue which needs to be put into the centre of domestic reform policies is that of managing the changing relative competitiveness of nations. This change needs to be reflected especially in the world's largest economy, viz. the United States.

Introduction

The world has been hurled into a new flux since mid-2007 with the onset of the housing and financial crisis which rapidly morphed into a global economic crisis in 2008. For most East Asian and Southeast Asian countries, however, this was a year-long trade crisis which at last appears to be bottoming out. The demand for Asian exports collapsed in the aftermath of the demise of Lehman Brothers in September last year; in the fourth quarter of 2008 and the first quarter of 2009, quarter-on-quarter growth rates of exports declined by close to 60 percent in the Asian newly-industrialising economies (NIEs), by about 30 percent in Japan and ASEAN-5, and by 50 percent in China and India.[2] Though the freefall of global trade seems to have been arrested in the past month, global trade volumes are still expected to decline by some 10 percent in 2009, the worst decline in trade since the 1930s.

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[2] IMF Staff calculations, based on CEIC Data.

There are many causes for the present financial crisis, with roots in the growing global current account imbalance,[3] in short-sightedness and excessive leverage at financial institutions, and basic failures in financial supervision and regulation. However, the argument that has gained in strength during the ongoing crisis is the role of global payments imbalances as one of the more fundamental underlying causal factors of the world's economic woes. Most economists, financial analysts and central bankers, including the present Chairman of the United States Federal Reserve, Ben Bernanke, and the current United States Treasury Secretary, Timothy Geithner, "attributed the large United States current account deficits to a savings glut in China and emerging markets, understating the role that excessive fiscal deficits and debt accumulation by American households and the financial system played".[4]

While the United States' arguments were aimed at highlighting the deleterious effects of excess saving in the rest of the world while underplaying the overconsumption effects, even the central bankers from developing countries concurred on the larger issue of the unsustainability of large global imbalances. D. Subbarao, Governor of the Reserve Bank of India, recently argued that, "No crisis as complex as this has a simple or a single cause…but if we probe deeper, we will learn that at the heart of the crisis were two root causes – the buildup of global imbalances and developments in the financial markets over the last two decades".[5] The financial sector deregulation in the United States in the 1980s allowed markets to innovate, and the increasing securitisation of United States mortgages in the 1990s helped unleash a huge amount of liquidity that lifted markets everywhere. Data from Bloomberg show that the Dow zoomed around the time of this deregulation, rising from a level of around 1,000 in 1980 to nearly 11,000 in 2000 and crossing 14,000 just ahead of the onset of the current financial crisis.

A part of this liquidity also went to the riskier emerging markets as market- and efficiency-seeking investments by multinational corporations (MNCs), especially as certain productive activities started becoming uncompetitive at United States costs. This began the cycle of repatriating profits and net capital outflows from developing countries. This trend was subsequently reinforced by the recycling of trade surpluses (a major part of which was due to the exponential growth of intra-firm and intra-industry trade in the later part of the 20th century) of Asian countries.[6] The increasing foreign exchange reserves by the surplus

[3] The phenomenon of "growing imbalances" in the world economy is popularly understood as the changes in current accounts of major actors, with the rising United States deficits receiving special emphasis in recent discussions. The current account balance of a national economy or a group of economies is a statistical construct, which highlights cross-border linkages of productive processes (through external trade) and capital/labour movements (through interest, profit and wage remittances). Moreover, current account balance is also the starting point in estimating net resource flows from and towards a national economy (or a group thereof).

[4] Roubini (2009a). Ben Bernanke in a 2005 speech asserted that rather than the United States saving too little, the rest of the world saves too much, and made it fashionable to focus on the savings-investment balances of surplus countries as a key perpetrator. One of the most developed models is presented in Caballero, Farhi and Gourinchas (2008). The perspective of excess saving outside the United States as the primary cause of low interest rates is echoed in the comments of Lawrence Summers, Bradford DeLong, and Richard Cooper at the 2008 conference where the paper of Caballero and others was presented.
Within the context of the world balance of payments, a deficit at one of the major blocs has to be compensated by a surplus somewhere else. Well-known macroeconomic identities show that such a situation signifies low savings with respect to investment in the former and vice versa in the latter. Aggravation of global imbalances occurs when the gulf between the two ratios rises. The search for causality may be an impossible task since the two processes are supposed to be simultaneous.

[5] ASSOCHAM JRD Memorial Lecture, New Delhi, 31 July 2009.

[6] Pettis (2009).

countries was an obvious indicator of the accentuating imbalance, notwithstanding the precautionary justification for the buildup of Asian trade surpluses after the Asian Financial Crisis in 1997-98.[7] A part of the Asian trade surplus was accumulated in United States dollars (estimated at around 65 percent of their foreign exchange reserves) since managed exchange rate policies and the trade financing requirements in Asia limited the ability of governments to diversify significantly out of the dollar.

In this paper, we analyse the role of different factors in creating the global imbalance, in particular, underlining the role of non-trade policies in the United States and China in creating and feeding the growing global imbalance, and based on that suggest the policy reforms that the United States must consider to help rebalance the global economy.

The Rise of China in United States' Trade Relations

The United States' current account imbalance with Asia has been deteriorating since 1980s. However, the United States-China bilateral trade imbalance and build-up of reserves since the turn of this century in particular, are regarded as the most important contributors to the ballooning global imbalance in the past few years, though generally the continuing United States imbalance with the East and Southeast Asian economies (in aggregate) is cause for equally serious concern.[8] In the last decade of the 20th century, the United States household savings also started to nosedive. Excess consumption in the United States was financed by net dis-saving (as discussed, the United States became a net importer of capital), a large part of which was reflected in rapidly increasing trade deficits vis-à-vis the rest of the world since 2001 and, in particular, vis-à-vis trade in goods with China.

Data collected by the National Bureau of Statistics, China, reveal a strikingly sharp rise in China's total trade as a percentage of gross domestic product (GDP) since China's entry to the World Trade Organisation (WTO) in 2001.[9] The latter evidently ensuring rule-based market access for Chinese exports into the western markets, alleviating the uncertainty of having to renegotiate market access conditions annually with individual trade partners. This certainty also favoured the United States-China trade, and the United States bilateral merchandise trade deficit with China ballooned from around 2003 onwards, until the onset of the financial crisis in 2007. Of course, the fact that most of the East Asian exports started to flow out of China by this time did add to the growing bilateral trade imbalance, with the changing competitiveness and consequent splicing of production processes in the region enabling China to become the final assembly hub for many of the region's exports to the rest of the world.

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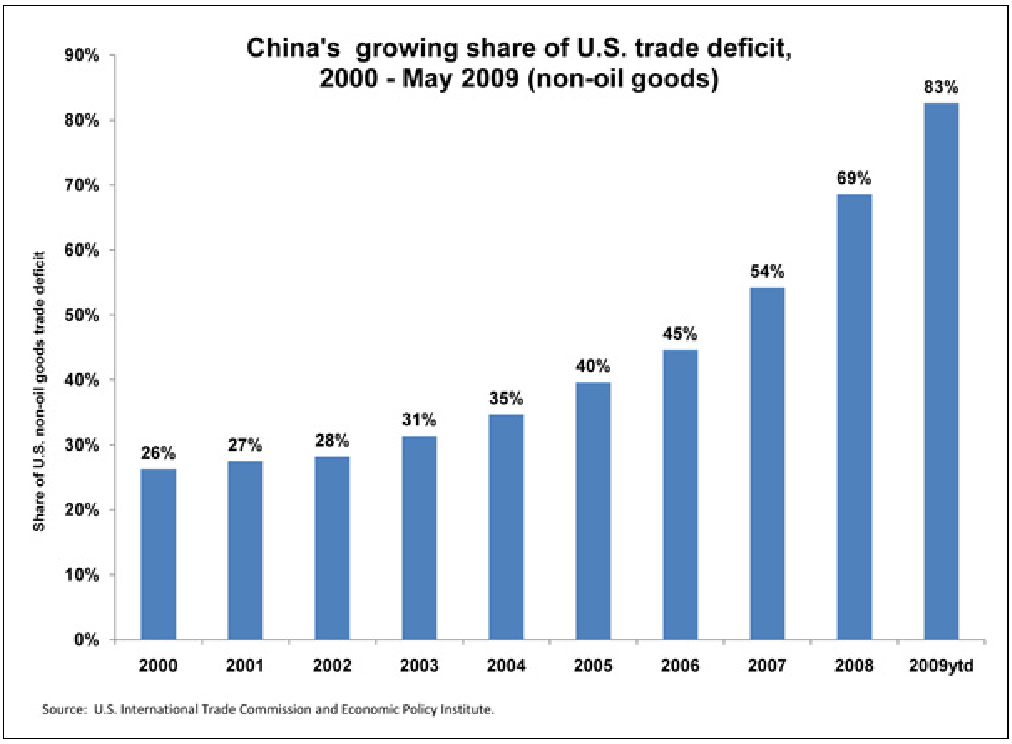
[7] The Deputy Managing Director of the International Monetary Fund, Takatoshi Kato, suggests that the myth that large stocks of foreign exchange reserves offer an effective insurance against capital account crisis has been dismantled in the **current crisis.** The vast build-up of Asian reserves during the past decade certainly came in handy during the massive wave of the financial turmoil last September-November. However, the high levels of reserves were not able to insulate Asian economies, and the real and financial strains in the West were still transmitted to Asia.

[8] Germany and Japan are the other two major world economies with unsustainable trade imbalances (though not vis-à-vis the United States), but the sheer scale of the imbalance between the United States and China and the relatively larger impact of the world's two largest economies appears to be at the root of this global obsession with the United States-China trade and financial imbalance. It also needs to be remembered that since the late 1970s, United States has run sustained trade deficits with the East Asian countries, beginning with Japan, followed by the NIEs and then ASEAN-5 nations.

[9] Kroeber (2006).

The 2007-09 recession did help to mitigate a part of the above imbalances, as the United States consumers started saving at their fastest pace in 15 years. The United States household savings rate rose to 6.9 percent in May 2009 (equivalent to annual savings of US$750 billion in today's economy), the highest since December 1993, as increases in personal spendings were less than increases in incomes (the rate in April 2008 was zero). Furthermore, the current-account deficit of the United States, which includes trade in goods, services and income transfers, narrowed in the first quarter of 2009 to its lowest since 2001 as Americans saved more and bought fewer imported goods (the discretionary spending component). The United States current-account deficit has shrunk dramatically from almost six percent of GDP in 2006 to less than three percent of GDP in 2009. Taken by itself, the increased household saving has the potential to eliminate almost all of America's dependence on foreign capital.[10]

China has also increased domestic spending in order to counter the effect of the recession on its domestic economy. The Chinese trade surplus is shrinking because the country's economic growth in 2009 reportedly came from domestic demand which requires continued imports, though exports continue to remain weak.[11] China's merchandise trade surplus has narrowed to US$35 billion in the second quarter of 2009, a 40 percent year-on-year decline, which when translated in real terms is even more impressive. Goldman Sachs estimates that after adjusting for changes in prices, China's export surplus in the second quarter of 2009 will have shrunk to less than a third of its level a year ago, even suggesting that a monthly trade deficit is possible in the near future. However, the United States-China bilateral trade continues in the same pattern as before. Recent data from the United States International Trade Commission and Economic Policy Institute indicate that China's share in the United States non-oil merchandise trade deficit has grown and while the United States monthly non-oil trade deficit declined to 53 percent in the past one year, China's share in this deficit has surged from 69 percent in 2008 to 83 percent through May 2009 (see the chart below).



10 Feldstein (2009).

11 China's reported economic health in the face of continued weakness of exports has led many analysts to contest it. Makin (2009) argues that this is a 'bogus boom' running on liquidity and creative accounting.

It would thus appear that the underlying causes of growing United States-China bilateral imbalances have accentuated in the current recession, with the trade imbalance continuing to be a key contributor. While United States consumers seem to have tightened their belts, the interplay of the counter-cyclical macroeconomic and financial policies adopted by the various national governments seem to have done little to help unwind the global imbalance, a key perpetrator of the worst global economic recession since the 1930s. In fact, recent data indicates that though the global economic freefall seems to have been arrested, the prospects of a global recovery (ex-China and India) continue to be anemic at best.[12] This requires countries to actively work at deviating from their complacent "business-as-usual" models and search for viable and sustainable policy options for domestic economic restructuring and reorientation in order to moderate the imbalance over time. Using the recession as a correction mechanism and stabiliser is a rather painful way of effecting the much needed economic restructuring; rebalancing via the recession is hardly recommended. Furthermore, with a (albeit modest) recovery in sight, the incentives for policymakers to inflict painful restructuring measures on the already hurting electorate will diminish.

In trying to understand whether and how the global imbalance can be unwound so as to have minimal costs of restructuring, we first discuss whether China's mercantilist policies are the main cause of accentuating global imbalances and reserve accumulation, and thereafter discuss possible interim policy options for the United States. The optimal solution for righting the internal imbalances in major economies without further adding to external imbalances is well known: consumers in the surplus countries must provide the growth impetus needed to replace the withdrawal of the United States consumer from the world economy. However, this is easier said than done. Economists now argue that the policy actions that have proved so effective in averting the worst recession since the 1930s from deepening into another Great Depression are working to perpetuate the extant imbalances rather than reducing it.

Is Trade Imbalance the Only Culprit?

Among the major causes for the existing global imbalance, the most vilified suspects are: trade imbalances arising out of the unbalanced global demand and supply situation and the consequent net saving imbalance of nations. It is a well-accepted argument today that the Asian countries have a high dependence on the markets of western-industrialised countries for domestic economic growth and development (the ill-famed export-led growth model or mercantilist policies).[13] As argued in the International Monetary Fund (IMF) report, much of Asia relies heavily on technologically-sophisticated, high-end manufacturing exports,[14] essentially high income-elasticity products, whose demand has collapsed. Thus, given that

[12] The favourable growth and profitability prospects of companies in most countries (across all economic sectors) are largely on the basis of cost cutting and improved efficiency, since sales continue to remain depressed. The higher-than-expected profits posted by financial institutions are "on paper, as forbearance and public subsidies are, for now, hiding their mounting losses": Roubini (2009b).

[13] But in fact, the notion of high intra-regional trade in Asia (intra-regional trade accounts for over 55 percent of total Asian trade) as a key source of regional growth appears a fallacy when corrected for intra-industry and intra-firm trade. In reality, a large fraction of trade within the region is intra-industry processing and assembly through vertically integrated production chains of transnational manufacturing companies (and many of them are American MNCs) that use the region as a base for global supply.

[14] In particular automobiles and electronic consumer goods, and electrical and electronic capital machinery that go into manufacturing of the first two sectors. These sectors also tend to exhibit a stronger cyclical response, and heavy reliance on financing, all of which contributed to increasing susceptibility to the financial crisis and more rapid deleveraging following the onset of the crisis of confidence. Source: IMF (2009), Chapter 1.

final demand for products from the region rested largely in demand from western-industrialised economies, and in particular the United States, it is argued that any sustainable increase in domestic or regional consumption will necessarily require structural changes of the economies in the region. A global economy over-dependent on American consumerism is therefore advised to reduce its dependence on United States imports, and boost domestic consumption in the surplus countries, most notably in East Asian countries such as China, South Korea and Japan. From the above, the most logical recommendation would be that the Asian economies (and in particular China) need to increase their domestic and intra-regional consumption of goods and services, thus reorienting domestic growth away from excessive dependence on extra-regional net exports.[15]

Insofar as the United States-China bilateral trade imbalance is deemed the most pernicious contributor to burgeoning global imbalances, the relevant question to ask therefore is how much of the United States deficit is explained by the Chinese surplus. In fact, the recent surge in Chinese reserves in United States dollars by US$178 billion to US$2.132 trillion[16] (despite the publicly-aired concern by several Chinese leaders about the sustainability of United States dollars as global store of value) does indicate that there is a huge short-term self-interest on the part of the Chinese in not forcing America to reduce its capital inflows too quickly. However, it appears that the primary cause of China's most recent reserve accumulation is not the great surplus of its exports over its imports, but the domestic financial and fiscal policies. This has resulted in a surge of liquidity (not all the directed bank lendings are deployed in productive investment yet[17] and a major part of the stimulus spending also has been saved) that has – somewhat counterproductively – flowed into stocks, property markets, commodity stockpiles, and consumer durables (with the help of special incentives for purchases of durables). Higher corporate savings, and the excess liquidity temporarily held in currencies and liquid assets, are presently bolstering the net reserve position of China.

But how important have trade surpluses been in building China's massive United States dollar reserve chest? It is important to assess the extent of which the reserve accumulation and the savings glut in China (and also other Asian economies) has depended on trade surpluses. As an illustrative case we analysed the United States trade balances vis-à-vis China. Data released by the WTO[18] indicate that US$295 billion of China's merchandise trade surplus (assuming all of China's trade is with the United States) can explain about a third of the US$865 billion merchandise trade deficit that the United States registered in 2008. In the same year, however, the United States registered a US$130 billion surplus in its commercial services trade with the rest of the world, reducing its trade and services deficit to US$735 billion. The United States-China bilateral trade deficit was US$268 billion in 2008, having increased by US$10 billion over the 2007 trade deficit.[19] Thus the huge United States deficit of six percent of its estimated US$14 trillion plus GDP cannot be explained in its entirety by the United States-China bilateral trade imbalance, though the latter did help sow some of the seeds of this imbalance.

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15 Almost all economists and western policymakers, analysts from all the multilateral agencies as well as consultants from private firms have inevitably recommended the need for Asia to rebalance its current account and reorient its demand pattern inwards. These voices were first heard in the aftermath of the Asian Financial Crisis a decade ago, but have become much stronger since 2002-03.

16 Vide Chinese reserves data released on 15 July 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=alZgI4B1lt3s.

17 Makin (2009, *op cit*) argues that while the measured pace of China's increase in production is rising, the public works projects and actual spending already recorded are falling behind schedule.

18 World Trade Report 2009, Chapter 1.

19 US DOC May 2009 Release: http://ita.doc.gov/td/industry/otea/ttp/Top_Trade_Partners.pdf.

However, focusing on the bilateral trade balance misses a bigger and more important story. As Greg Mankiw argues that while the bilateral trade deficit is not fiction but rather meaningless statistic. Furthermore, the overall trade balance is inextricably linked to a nation's savings and investment; that is not true of a bilateral trade balance. As discussed in the earlier section, the United States-China trade imbalance in this decade is largely a result of a shift in the United States' trade with East Asia. The Asia Foundation Report (2008) on "America's Role in Asia" notes that by 2006, China replaced the United States as the number one trading partner of Japan, South Korea, Taiwan, and a number of Southeast Asian countries. Furthermore, the United States' trade deficit with the rest of the world has grown more than that with China and East Asia. Between 1998 and 2007, the share of the rest of the world in the United States' trade deficit grew from 25 percent to 51 percent.[20] It may be recalled here that in the face of its falling international competitiveness, the United States has, since the late 1970s, consistently used trade imbalances as an excuse to protect domestic industries from foreign competition.[21] The United States' rhetoric on the savings surplus that emerged in China in 2005 and the subsequent years is, in some respect, reminiscent of the debate between the United States and Japan on the origins of the two countries' external imbalances in the 1980s. In that period, United States economists emphasised excess saving and a current account surplus in Japan as primary causes of the external imbalances between the two countries.[22] However, it is time that the country's policymakers targeted the more important perpetrator of the United States' trade woes, namely, the declining United States competitiveness in a large group of consumer industries.

How to Unwind the Imbalances: Options for United States Policymakers

Assuming that policymakers are willing to take hard decisions and enact necessary reforms, what can be the least disruptive manner of restoring balance and restructuring large economies at a time of global economic weakness? Furthermore, it needs to be evaluated whether or not this reorientation is feasible. While the basic logic of the above recommendations is accepted, countries should not rush into adopting mitigation policies without a careful analysis of their medium-term impact. In a recent blog entry, an European researcher has in fact questioned the merits of reorienting China's (and by extension Asia's) economic growth model, noting that contrary to popular belief, China's growth has always been investment-led rather than export-led.[23] It has been estimated that the composition of the Chinese economy in recent times has been 40 percent investments, 40 percent consumption, 10 percent net exports, and the rest is government consumption. However, over 80 percent of China's growth this year will be state-directed, either through public spending or officially-induced lending, and the government's share in consumption is likely to rise further. A decomposition of the ongoing Chinese stimulus programmes shows that about 72 percent of

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[20] See the chart on Composition of the United States Global Trade Deficit, US-China Business Council (2008) report on "US-China Trade in Context", http://www.uschina.org/public/documents/2008/04/us-china_trade_in_context 2008.pdf.

[21] Baldwin and Richardson (1984): By the 1970s the United States' export competitiveness was no longer unchallenged, which led to changes in attitudes and approaches of the United States' politico-economic engagements with other nations and its trade policy initiatives and negotiations. The change was manifest in that after 1970s, the United States' trade policy insisted on the inclusion of non-tariff escape clauses allowing the United States to modify or withdraw tariff reductions if increased imports resulting from a concession that was deemed have caused/threatened to cause injury to domestic industry (i.e. alleged 'unfair' trade practices by partners).

[22] Bosworth and Flaaen (2009).

[23] Fredrik Erixon (2009): http://www.ecipe.org/blog/re-orienting-china2019s-economic-growth-2013-do-we-really-want-it.

China's massive US$586 billion stimulus (about 14 percent of the Chinese GDP) is devoted to infrastructure creation (at the national level). If we add the local and municipal stimulus programmes to this, and if the bank lending programmes are also encouraged, the share goes up further. Thus simply reducing export shares may not reduce the net savings, unless other non-trade policy changes are also initiated.

Moreover, the net reserves accumulation is more than a function of the net trade surplus. Financial policy and savings management plays an important part in this. As argued by Michael Pettis (2009) and Nicholas Lardy (2008) among others, building consumer-centric economies in Asia would call for a reorientation of domestic fiscal and financial policies in a manner that eliminates financial repression (defined as low or negative real return on deposits), especially in China. Many analysts have long pointed to exchange-rate manipulation as a quick fix for trade imbalances. However, as past experience has shown that unless commensurate domestic policy changes are undertaken, a currency appreciation need not necessarily lead to a decline in bilateral trade imbalances. In response to the Plaza Accords, Tokyo directed a flood of low-interest credit into the manufacturing sector while informally guaranteeing corporate borrowers. Manufacturers increased production for export markets even as household consumption declined. The trade surplus with the United States increased. China is trying to do the same thing, despite a rising yuan. The country's policies include low lending rates enforced by the central bank, energy and commodity subsidies and most importantly, a flood of implicitly-guaranteed credit aimed at investment in infrastructure and the manufacturing sector. The outcome is a rising trade imbalance from 2003-07, despite the steady depreciation (real effective) of the United States dollar vis-à-vis the yuan from February 2002.

Furthermore, after the Asian Financial Crisis of 1997-98, the countries in the region have strengthened their external payments and absorbed the excess supply of foreign exchange by accumulating large amounts of reserves as a self-insurance against the sudden stop and reversal of capital flows. To that extent therefore, maintaining the value of these reserves becomes critical. However, banks are the biggest beneficiaries of financial repression, though the latter provides enormous implicit subsidies to corporates, and the high profitability of the favoured few[24] are at the expense of other businesses as well as consumers. All this has led to a further accumulation of savings, which in view of the official policy of limiting the agents and modes of savings management and reserve accumulation, results in a narrow band of options in which the Chinese reserves can be stored. In fact, more problematic than providing for low-interest credit and incentivising production for exports, are the Chinese financial sector policies that require all business savings (other than reinvested earnings) to be deposited with the central bank for the proper channelling of savings. The Chinese central bank then uses these savings mostly to buy the safest instruments, namely the United States Treasury bonds. The central bank deposits add to the accumulation of United States dollars as reserves in China.[25] Thus, it can be argued that domestic fiscal and financial policies were the

[24] It has been argued that from 2000 to 2005, savings vis-à-vis GDP in the household and corporate sectors in China rose from 14.8 percent to 16.2 percent and 15.5 percent to 20.4 percent, respectively (Kuijs, 2006). In recent years however, corporate sector earnings have improved tremendously, especially in the state-owned enterprises that have a strong monopoly in their markets. These enterprises are not obliged to pay dividends to the government, and so the abundance of their internal reserves become the saving of the corporate sector and pay for new investment. Of course, in this case, wasteful investment is aggravated because the cost of raising funds is effectively zero.

[25] China does not release the currency composition of its reserves, but the dollar is thought to make up around 65 percent of the portfolio; that share could actually have increased slightly in Q2. Euro assets make up most of the rest, along with a small amount of pound sterling, yen, and likely even a small amount of Canadian

more important perpetrators of the current account imbalances than the much maligned trade imbalance. In fact on the contrary, determinants of international trade imbalance include anything that affects domestic consumption and production, or in other words, any domestic policy. A freer capital account is a positive and necessary step on China's long-term path towards economic modernisation and consolidation as a global economic powerhouse, but is unlikely to resolve the current account imbalances on its own.

Nonetheless, it is not only the Asian economies that need to reform their domestic policies to ensure that the unwinding of the global imbalances is sustainable. China can help, but it remains a relatively poor country to be able to shoulder the major burden of adjustment. It is also argued that progress is already being made in reducing global imbalances; but there is no guarantee that this process will continue, or be sustainable. Studies by William Cline and John Williamson at the Peterson Institute suggest that the United States' current account deficit will rise back above five percent by 2012 and soar into unprecedented terrain thereafter, unless the budget deficit is reduced sharply and the dollar depreciates substantially. In the absence of an alternative store of value and reserve currency (at least in the medium term),[26] the dollar is unlikely to weaken to the extent necessary to restore balance and competitiveness unless drastic occurrences take place.

The contention in this paper is that the United States has an important leadership role to play in the above restructuring, one that goes beyond the increases in household savings and has to begin with the acknowledgement that unless the United States' competitiveness is restored, the trade (and current account) imbalances will continue to remain at unsustainable levels. This is not to suggest that the United States is not a competitive nation. It remains one of the most efficient producers in many capital goods and high technology industries, and also in a wide range of services. However, over time, the United States has lost its competitiveness in many consumer goods industries, partly as a result of strong trade union activism which raised the wage costs. This is also caused by a transport and technology-led integration of the world's production processes, which added nearly three billion Asian labourers into the global production processes, thereby hugely altering the intra-regional comparative advantages. Stakeholders in the United States need to lobby for, or adopt policies that reflect this change.

If either through minimum wage legislations or physical rationing of foreign labour inflow (usually resulting from special group lobbying and trade union pressures), the costs of domestic labour is maintained above the international average, profit-maximising companies will either relocate their production/outsource or move to higher-value added production processes that can sustain the higher costs. Both have happened in the United States since thte

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and Australian dollars. China has also increased its gold holdings. Despite the increase, gold makes up a less-than two percent share in Chinese reserves, much smaller than its share in United States or European reserves.

[26] Can Special Drawing Right (SDR) work as the alternate reserve currency, as proposed by China? Economists say that to be viable global traders would have to begin denominating transactions in SDRs instead of dollars, and there is no sign of that happening anytime soon. Richard Portes of the London Business School says using SDRs as the top international currency is "not impossible," but he adds that "the fundamental problem is that the issuer of the [international] currency also has to be the lender of last resort. The IMF does not have the legitimacy to do that." Also, the store of value function of a reserve currency is important. SDR derives its value from the economies whose currencies it is valued on. And like the strength of a chain is its weakest link, SDRs value will depend on the strength of its weakest currency, and thus add to volatility. Dollar's supremacy and status as the world's reserve currency seems certain for the next decade and half, unless the present balance of payments system implodes as in the inter-War era.

1970s, with disastrous long-term consequences. The efforts of Detroit automobile makers to win protection from Japanese competition in the 1980s did give them temporary respite, and helped maintain the American standard of living for the United States' auto workers. However, after 25 years and having experienced the great recession, the United States automobile industry lies in shambles, with the firm realisation that unless operations are changed drastically, life is going to be even more difficult. Today, the United States automobile unions have volunteered for pay-cuts or the freezing of salary payment to retain what remains of the United States' competitive edge. It need not have come to this, had the corrective measures to address the key competitiveness issue been addressed in the 1980s.

On the other hand, most consumer industries responded to rising wage costs by relocating production facilities. These return to the United States as imports to satisfy the United States consumer demand. Returning to semi-autarky and the localisation of production (a hugely popular idea these days) will at best retain some economic activity at home but at the expense of the consumer; a sure recipe to force the United States economy back into a low-growth equilibrium for some time to come. Moving to higher-value added products also has its own limitations. First, there is a limit to which new and more higher-value-added activities can be identified and the economy restructured suitably. Second, and more importantly, such upgrading is almost always capital- and technology-intensive. The mass of the low- and semi-skilled population in the United States needs new employment opportunities.

Unless the United States accepts a much higher rate of unemployment as the new norm, creating new economic activities that can re-employ the laid-off and new job seekers may call for lowering the average wages and wage expectations. This will also help restore the economic viability and competitiveness of some of the economic activity that had to be moved offshore in the past few decades. It will not be easy to convince an already hurting populace to accept weaker wages, but the recession has already revised wage expectations downward and policies can be instituted that will ensure this weakness persists – reforms by stealth, which requires immense vision, political will and connivance. The government will also need to allocate more to social sector spending. However, over time, this will reverse the present highly-skewed situation whereby the United States wage income as a share of GDP has been progressively and rapidly declining for the past half a century.

A critical lesson of the recent rise in racial antagonism in the developed countries needs to be interpreted to also include the very real angst of those middle-income members of the society, especially those who are not college graduates, who have had to bear the brunt of economic change bred by globalisation and technological transformation. Even before the recession, the decline in the number of well-paid jobs in manufacturing hit the incomes of this group of Americans hard. This group is now even more rapidly denied the chance to make a decent living, as the now-obvious structural shift of the United States economy away from industrial production has compounded the problem. This trend needs to be reversed simply to avert potential adverse social fallouts and insurrections, and one simple solution would be to adopt domestic industrial policies geared towards increasing the competitiveness of products and processess that can employ the mass of moderately-skilled United States job seekers. The lesson from industrial success is that adhering to fundamentals of commerce is a must – give what the consumer wants, control costs and deliver value for money. The United States manufacturing industry seems to have lost this plot since around the 1970s, but it is not too late to relearn it.

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