

# **CRISIS AND CONTRADICTION IN THE WORLD ECONOMY**

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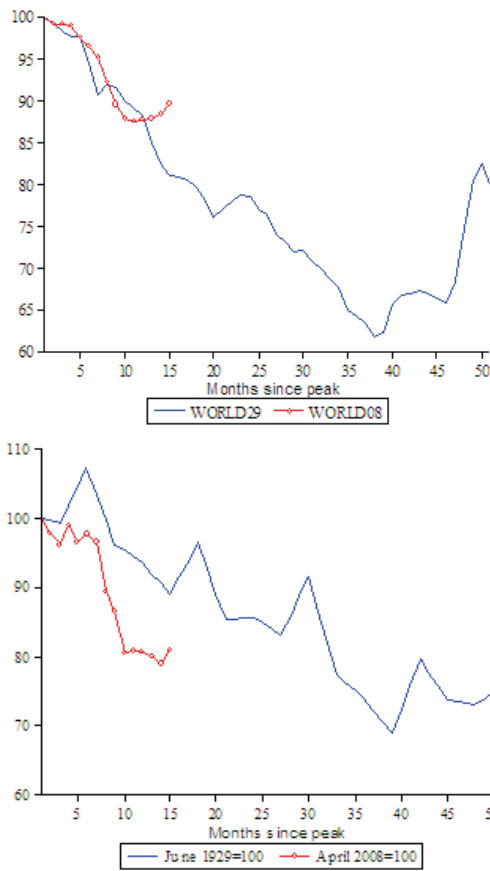
The current economic crisis has been the deepest in world capitalism since the 1930s, a fact now acknowledged by scores of mainstream commentators. This article provide an overview of the extent of the crisis by reference to data on trade, output, the stock markets, job losses and unemployment, making comparisons both with the Great Depression and other post-1945 recessions. It also considers the evidence for a bottoming-out in the economic freefall in the second quarter of 2009, as well as the reasons for it. The bulk of the article, however, is devoted to an examination of structural contradictions that persist in the world economy and which have either been exacerbated by the measures taken to halt the freefall or which have only temporarily been ameliorated. These factors include the accumulation of vast financial sector debt that has not been seriously tackled nor its dimensions understood, endemic excess capacity in the world economy, unsustainable public debt and stimulus packages, and a series of contradictions in the Chinese economy. The article concludes with an assessment of the prospects for the world economy.

## **Dimensions of the Crisis**

Figures 1-3 demonstrate that, for at least the first 12 months of the current crisis, the downturn tracked or was significantly worse than the Great Depression in terms of world industrial production, world trade and the stock markets. Figure 4 provides data on the drop in GDP in the G7 nations, with output falling by anywhere up to 7%, equivalent to

hundreds of billions of dollars.<sup>1</sup> In the first quarter (Q1) of 2009 business investment in the US fell at an annualised rate of 40%.

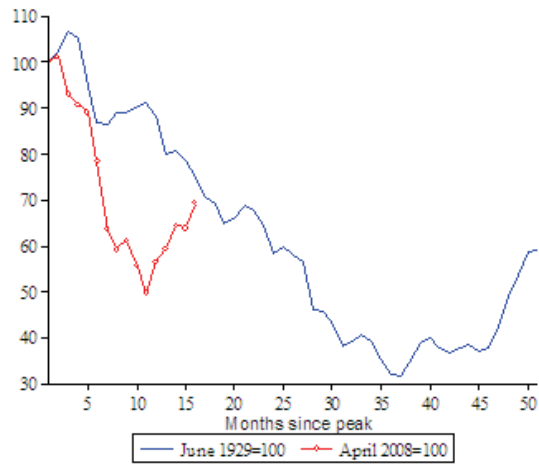
**Figures 1 and 2: World Industrial Production and Volume of World Trade, Great Depression vs. Today.**



Source: Eichengreen & O'Rourke (2009)

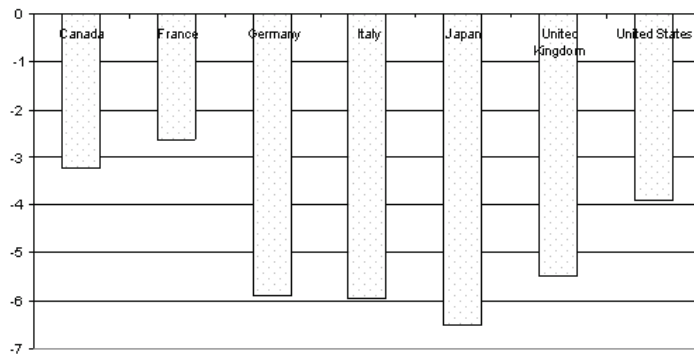
<sup>1</sup> Note all \$ figures in this article are US dollars.

**Figure 3: World Stock Markets, Great Depression vs. Today.**



Source: Eichengreen & O'Rourke (2009)

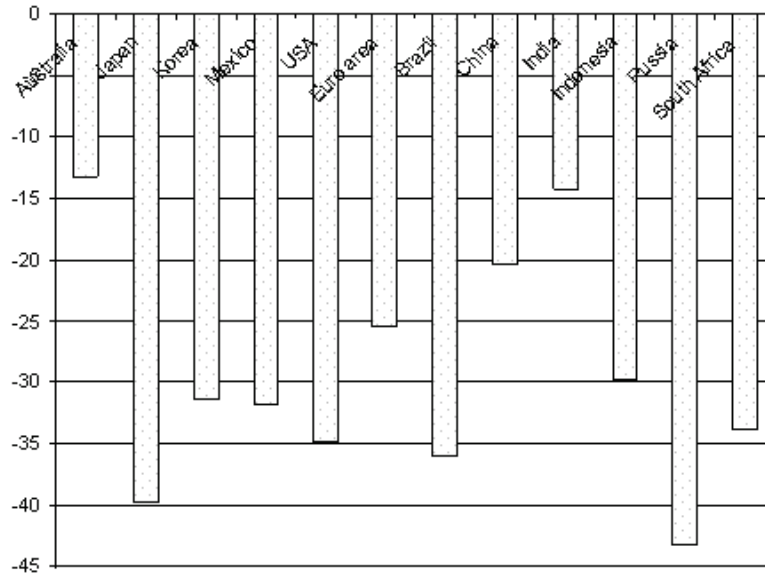
**Figure 4: Year on Year Change in GDP Q2 2009 (%)**



Source: OECD Statistical Extracts

A driving factor in the crisis has been the meltdown in world trade, as shown in Figure 5. Whether in the traditional core of the world system in the USA and Europe or in the so-called BRICs (Brazil, Russia, India, China), which were meant to save the system in the event of a crash in the core, imports fell by anything from 15% to nearly 45% in the year to the second quarter (Q2) of 2009, as shown in Figure 5. Deflation set in: prices fell across the G7 by 2.4% between Q3 2008 and Q1 2009 and in the US by 3.3%.

**Figure 5: Year on Year Change in Imports Q2 2009 (%)**

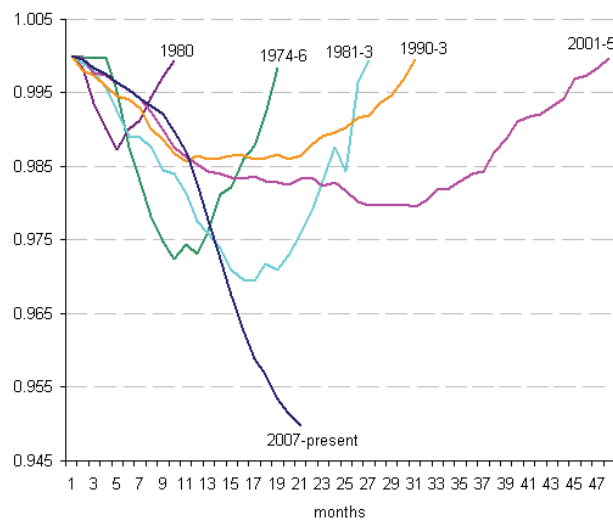


Source: OECD Statistical Extracts

The implications for the working class have been severe. With US government spending at 20% of GDP, as against 5% of GDP in the early 1930s, and the figure higher still in Western Europe, there is an automatic buffer against the kind of collapse in employment that we saw

in the ‘thirties.<sup>2</sup> Nonetheless, the situation is still dire: more than 18 months after large scale retrenchments began in December 2007, the scale of sackings in the USA has been significantly worse than in any other recession since 1945. More than seven million jobs have gone, as shown in Figure 6. By May 2009, the number of jobs in manufacturing in the developed world was down by 12% on a year previously (ILO, 2009a).

**Figure 6: Job Losses in Recent Recessions as a Share of Employment**



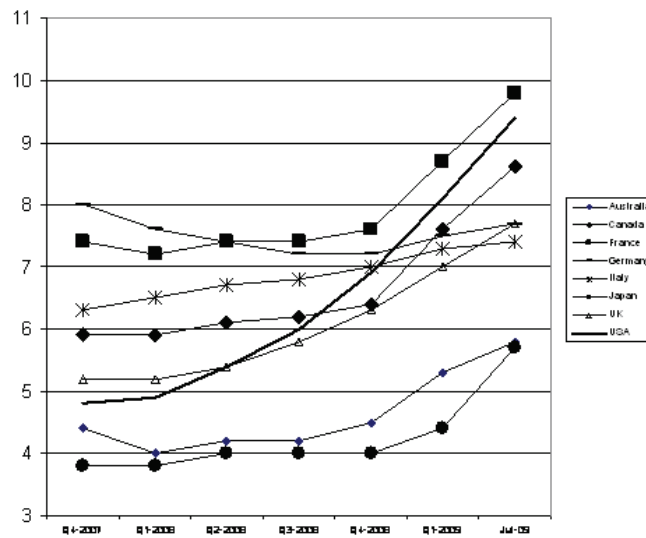
Source: Rampell (2009)

Across the developed world as a whole, unemployment was 46% higher in April 2009 than a year previously (ILO, 2009a). Sixteen million are

<sup>2</sup> Five per cent of all US jobs had disappeared by August 2009 when compared to November 2007. In the three years 1930, 1931 and 1932, net job losses as a proportion of total employment were 4.8%, 6.5% and 7.1% respectively (Schiller, 2009).

now unemployed in the US, and one in three have been out of work for six months or more. Another 22 million are jobless in the EU. Unemployment rates are rising steadily, as shown in Figure 7: in the Eurozone unemployment stands at 9.5% and is forecast to rise to 11% in 2010 (Jolly, 2009). In the Baltic States, which were regarded as economic miracles for most of this decade, GDP collapsed by 20% in the year to Q2 2009 and unemployment rose to 16-18% (Staeher, 2009). Unemployment has hit the young in particular: unemployment amongst teenagers in the USA now stands at 25% and at 18% amongst young workers aged 18-24 in the EU. Elsewhere, unemployment in Russia soared by two million between May 2008 and January 2009 (ILO, 2009b). Half of the unemployed across the OECD, and 80% globally, receive no jobless benefits (ILO, 2009b).

**Figure 7: Unemployment Rates (%)**



Source: OECD Statistical Extracts

If *underemployment* is added, the US total of workers either out of work or forced to work part-time for lack of full-time jobs was 17.0% in September 2009, up from 10.9% one year earlier (Bureau of Labor Statistics, 2009). Underemployment was on the rise across the G7 even before the onset of the crisis; the rate of increase has now speeded up. Half a million British workers are temping because they cannot find permanent jobs and one million are doing part time work because they cannot find full time jobs (Hyland, 2009). Others have simply dropped out of the labour market - participation rates are down everywhere.

Even amongst those still working full time, weekly hours and overtime have been cut back. Average weekly hours in the US private sector are at the lowest since 1964 (RGE Monitor, 2009). Total hours worked by production workers in US manufacturing fell by 16% in the year to August 2009 and are now 25% lower than in 2002 (Bureau of Labor Statistics, 2009). In Asia, working hours have been reduced across the board.

Employers are using the whip of unemployment to drive down wages and conditions. The Director General of the ILO reported in June 2009 that:

Freely negotiated collective agreements are no longer respected, and workers have to concede hard won wage levels and benefits in order to retain any credible prospects of future employment and income. The risk of clandestine labour or illegal child labour as cheap alternatives is growing in many countries, as is the recourse to forced or compulsory labor (ILO, 2009b).

In the USA the effect of a 2.5 per cent rise in hourly wage rates in the year to September 2009 was more than wiped out by shorter hours and inflation (Bureau of Labor Statistics, 2009). Hundreds of thousands of workers have experienced severe wage cuts. General Motors paved the way when it negotiated a contract with the UAW in 2007 to allow all newly hired workers to start work at half the going rate for established workers. The auto industry, the pioneer of high rates of pay for US blue collar workers, is now dragging wages down. One third of all US employers plan to introduce similar two-tier contracts when current

contracts expire (Bureau of National Affairs, 2008). The US is re-positioning itself as a low-wage economy after decades when manufacturing wages in the unionised sector were the envy of blue-collar workers around the world. All the while, US employers are pushing workers harder: labour productivity rose in the second quarter of 2009 at an annualised rate of 6.4%, as labour costs fell at 5.8% (Healy, 2009).

With unemployment on the rise, the 2008 US Census records that median household incomes fell sharply, by 3.6%, last year (Leonhardt, 2009). Household incomes are predicted to decline even more in 2009 given the further increases in unemployment during the year and are now lower than they were a decade ago. Such a decline has not occurred since the 1930s. *New York Times* journalist David Leonhardt points to the causes:

One, economic growth in the current decade has been lower than in any decade since before World War II. Two, inequality has risen sharply, so much of the bounty from our growth has gone to a relatively small slice of the population' (Leonhardt, 2009).

Forty million Americans now live below the meagre poverty line of \$22,025 for a family of four (Eckholm, 2009).

Along with capitalists in the private sector, the IMF and governments all over the world are intensifying the pressure. It was the Obama administration that insisted on wage cuts in the auto industry as a condition for the bailout earlier this year. In February the Irish government increased the pension levy paid by workers by 7%. The IMF, dominated by the governments of the major imperialist powers, is using the crisis to squeeze the weaker developed countries. The Latvian government, for example, was required to cut public sector wages by 10% in 2008 and is scheduled to cut them by another 20% as a condition of an IMF loan (Taylor, 2009). The Hungarian government, likewise, has cut pensions, social benefits and public sector wages on the orders of the IMF. The Icelandic government is slashing public spending in order to repay money loaned by the British and Dutch governments to bail out the bankrupt Icelandic banks which went under last year with debts equivalent to one-half of the country's entire GDP.



The crisis is having a devastating impact on many parts of the developing world as well. The Asian Development Bank reported in July that developing Asia is 'experiencing a precipitous drop in foreign direct investment' (Gittins, 2009). The crisis shut down export markets for raw materials and manufactured goods. The ILO noted in June that '[t]ens of millions of young people are about to leave school and enter a depressed labour market. A lack of decent work opportunities at an early age may permanently compromise the future employment prospects of youth' (ILO, 2009b).

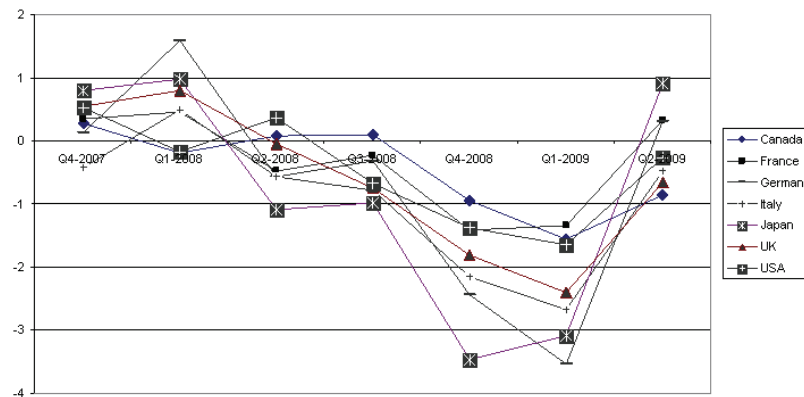
The crisis is also leading to a sharp reduction in remittances by the world's estimated 200 million migrant workers. The World Bank estimates conservatively that migrant remittances, which are worth approximately \$300bn and make a major contribution to poor families, will fall by more than 7% in 2009 as migrant workers are thrown out of their jobs and sent home. Foreign aid by OECD governments has been cut. This, on top of the food price inflation that occurred in the first half of 2008, has seen living standards squeezed for tens of millions. Food prices traded by commodity markets fell sharply in the first half of 2009 but prices in the shops have remained at record highs. As a result, the UN estimates that the number of hungry around the world will rise by more than 85 million to one billion in 2009 (White, 2009).

### **A (Temporary?) End to the Freefall**

In January and February 2009 the first mention of 'green shoots' began to appear from the mouths of leading government figures in the UK and USA. At the time this was no more than wishful thinking: GDP in Q1 2009 fell by as much as in the previous quarter as the world economy continued to plummet. However, by June economic data began to suggest that the freefall was indeed ending, and by August the talk was of a 'recovery' under way. Figures 1, 2, 3 and 8 demonstrate the basis for this optimism. After two quarters of sharp retreat, the rate of decline in GDP in the G7 economies slowed down, with positive growth recorded in France, Germany and Japan. China, which appeared to be slumping to only 6% growth in the first quarter (well below the rate required to keep unemployment from increasing sharply), was back on track to 8% by

August. After catastrophic slumps in GDP in Q4 2008 and Q1 2009, growth returned to Singapore, Korea, and the Philippines in Q2 2009. The rate of price deflation began to slacken.

**Figure 8: Quarterly Change in GDP (%)**



Source: OECD Statistical Extracts

Other indicators confirm the appearance of some feeble ‘green shoots’ during 2009. For example, the various international Purchasing Managers Indices, which measure current manufacturing activity and which had fallen to the low 30s in December 2008, had recovered by August to the low 50s (50 indicating the break point between contraction and expansion): this was the highest level for between 16 months and two years. Similarly, the OECD’s Composite Leading Indicators bottomed out in March 2009 and began pointing towards recovery (OECD, 2009a). House prices in the US edged upwards in June and July, albeit to a level still 15% lower than a year earlier (Standard and Poor’s 2009). After months when every successive prediction for growth and every report on past results was being downgraded, predictions for 2010 are now being modestly upgraded.

Three things have been responsible for an end to the freefall since April 2009. The first was the easing of the world’s credit markets due to the

government guarantees (i.e. open taxpayer-funded cheques) given to the banks over the northern winter. The US alone has shored up the big banks with \$250bn in taxpayer funds since late 2008. US economist Joel Geier suggests that the total of bank subsidies, loans, credits and guarantees by the US Government amounted to \$13 trillion (Geier, 2009). The result was that the banks regained confidence that money lent to other banks would not evaporate, and credit began to flow again, albeit by no means as freely as before.

The second factor has been the massive stimulus packages by the USA, Japan, China and the European Union. The USA has thrown in a stimulus package of \$787bn, China, about one third of the size of the US economy, has devoted more than \$585bn to boosting spending and infrastructure, Japan, \$270bn, and the EU, \$290bn. Across 50 countries, stimulus packages totaling \$3 trillion have been unleashed. In the Great Depression, the budget deficit averaged across the 24 largest economies was less than 4% of GDP. In the USA and the UK in 2009, thanks to stimulus packages, it was 12%. The effect of the government stimulus packages was boosted by lower oil prices and lower mortgage rates. All over the world big government is back in favour as the 'market solutions' beloved of the neoliberals are quietly pushed into the background. Production in the auto industry began to recover in the northern summer of 2009 with the 'cash for clunkers' deals by American and German governments.

The third factor responsible for an end to the freefall was the decision by the major central banks to print money and reduce interest rates to virtually zero in late 2008. Again this is in sharp contrast to their reaction in the Great Depression when the central bank rate in the major economies never fell below 3%. This time around, money supply expanded rapidly, whereas in the Depression money supply collapsed.

Aggressive and semi-coordinated action by governments around the world has therefore halted the catastrophic drop in all the major indicators experienced in the northern winter of 2008-09. This has not, however, ended the crisis. These measures are essentially unsustainable and in the long term only create their own problems.

## A Systemic Crisis

We are currently experiencing a systemic crisis in the world economy and there is little prospect of sustained economic growth returning to the world economy in the next few years. The more sober-minded mainstream commentators recognise the depth of the crisis and the fragile character of the 'green shoots'. The United Nations Conference on Trade and Development argued in September 2009 that 'The likelihood of a recovery in the major developed countries that would be strong enough to bring the world economy back to its pre-crisis growth path in the coming years is quite low.' (UNCTAD, 2009: i). US Treasury Secretary Timothy Geithner told the US Congressional Oversight Panel in the same month that '[w]e still have a long way to go before true recovery takes hold' and pointed to 'substantial headwinds' from the financial sector because of foreclosures continuing at an 'aggressive pace for some time' (Crittenden, 2009). The *Wall Street Journal* in August 2009 referred to 'a barrage of negative reports' in the middle of that month amidst all the hyperbole about the recovery in the stock market: 'personal bankruptcies surged 34% in June compared with last year, the number of homes subjected to foreclosure proceedings rose 32% as against a year ago; the number of people out of work for 27 weeks or longer reached a record 5 million; and retail sales dipped in July' (*Wall Street Journal*, 17 August 2009).

A series of factors continue to weigh on the system, some of which have their origins in the factors that brought on the freefall in the northern winter of 2008-09, and some which arise from the very measures that were taken to arrest the collapse.

## Mountains of Financial Sector Debt

The main means by which capitalism resolves its crises is by destruction of capital through recessions and wars.<sup>3</sup> Since 1945, however, governments have been reluctant to allow the clearing-out process to

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<sup>3</sup> The treatment of crisis that follows in this section and the next rests on an analysis set out by Harman (2009), Chapters 8 and 9.

work its way through for fear of multiple collapses following the failure of one or two large companies. The result was that the crises of the postwar decades were shallower but also that the recoveries were also not as rapid or large. In the past 10 years the situation has changed a little as the US government has allowed some large companies to go bust (e.g. Enron, WorldCom, and now Lehman Brothers) but the experience of the last was that the costs were simply not worth it. The entire financial system threatened to melt down as banks refused to lend for fear that their debtor too would go out of business. In order to tackle the credit crunch, the US Government injected billions of dollars to bail out the banking system. However, although huge quantities of capital, both fictitious and real, have been wiped out in the current crisis, including the bankruptcies of some giants of corporate America such as GM and Chrysler, the destruction has been insufficient to allow the system to fully rebound.

The IMF estimates that total write-downs in the global banking system amount to \$3.4 trillion (IMF, 2009). Less than half of this has so far been accounted for and dealt with. As the losses are gradually unwound, prudential regulations require banks to cut their lending by ten times the amount of the losses revealed – a deleveraging process of up to \$34 trillion. The banks have only just started down this road.

Uncertainty about the exact extent of accumulated write-downs means that the sheer extent of potential bank defaults is shrouded in mystery. In August the US Congressional Oversight Panel declared that '[i]t is impossible to resolve the argument about whether banks are or are not solvent because of the uncertain value of their loans' (O'Connor, 2009). Early in 2009, fearing further collapses in the banks, President Obama allowed US banks to revalue their 'assets' (the various toxic debts, the derivatives and so forth that precipitated the crisis in the first place) to their original 'book price' rather than their likely price if sold presently on the open market ('mark to market'). This has allowed US banks to report a return to solvency. This suits US banks and the US Government but in the long term prevents a full resolution of the crisis that might accompany the kind of wholesale write-down of assets necessary for a reboot of the US financial system.

While the major US banks were bailed out with virtually unlimited funds from the US government earlier in the year, the US banking system as a whole was in a worse state in Q2 than Q1 as banks were hit by a sluggish economy and rising unemployment (Morgenson, 2009). The US housing crisis which sparked the financial crash is still in play. Sub-prime mortgages are faring worse than they were a year ago: 40% are now overdue (Timiraos, 2009). Delinquency rates on prime mortgages, the 'gold standard' of the US banking system, have risen from 5.3% to 9% (Timiraos, 2009). Further weighing down the market is the increasing proportion of mortgage holders stuck with 'negative equity', that is, they owe more on their mortgage than their house is worth. The figure is already one quarter of the total and is predicted by the Deutsche Bank to rise to one half by 2011 (Pethokoukis, 2009). With no end to the sackings in sight in the US, the housing market is not likely to recover quickly. Thus the banking system will continue to be bogged down with bad debts.

Speculation is rife that there may be a second round of financial failures in the US sparked off by a collapse in commercial real estate (Pristin, 2009). The IMF estimates loss rates of 27% on commercial mortgage securities in the USA, UK and Europe (IMF, 2009). Building values have fallen as much as 50% around the USA and there are dire predictions for refinancing commercial mortgages (Pristin, 2009). Unrealised losses on their holdings of commercial real estate are a deadweight on the banks' balance books and further hinder their preparedness to lend. Bank credit, generally, is in sharp retreat.

The situation is worse again in Europe where banks have double the leverage of the USA. European banks still need to raise about \$380 billion to right their books (IMF, 2009). Bank write-downs in the UK amount to \$604bn, of which only one third has thus far been taken (IMF, 2009). Banks in Austria and Sweden are taking heavy hits because of investments in Eastern Europe. During the boom years of 2002-06 Eastern European businesses and householders took out loans denominated in Euros to take advantage of lower interest rates. With the rise of the Euro and the collapse of their own currencies during the current crisis, the repayments are crippling them. Further defaults are likely, threatening a chain reaction in the Western European banking

system. The flood of foreign investment into Eastern Europe in 2007 and 2008 has now turned into a flight as banks and investors try to get their money out.

### **Endemic Excess Capacity in the World Economy**

Although the rate of profit is higher in the major economies than during the 1970s, it is still insufficient to prompt the revival of capital accumulation (Brenner, 2009; Harman, 2009: 195-201; 231-38). This is significant because it exacerbates another systemic problem in the advanced economies, excess capacity. Traditionally, the gap between production and working class consumption is met by business investment. However, business will not invest where the rate of profit is inadequate for its needs. Robert Brenner records that capital accumulation in the major Western economies has been successively lower in every decade since the 1960s (Brenner, 2006: 282). With no sustained recovery in profitability in sight, the capitalists are not going to gamble on investing in production of new goods for sale onto glutted markets. Lower rates of capital accumulation may restrain the rise in the organic composition of capital, and therefore slow down the tendency for the rate of profit to fall, but they do nothing to solve the problem of excess capacity and only hold back long term growth in productivity. In Japan, where excess capacity has been most obvious, the economy stagnated for 14 years, the so-called 'lost decade'. With the onset of a fresh crisis, the problem of excess capacity in the advanced economies has become more urgent. Manufacturing in the EU and USA is now operating at 70% capacity. In addition, bank lending to business for investment is constrained by the banks' own underlying solvency problems and the weight of toxic assets on their books.

If business will not step into the breach of inadequate effective demand by expanding investment, what of working class consumption? Here the capitalists are stuck with an inherent contradiction. Governments around the world would like households to spend up to reflate their economies. This is particularly important in the USA where consumption accounts for 70% of the total economy. However, at the same time governments are using the crisis to attack working class wages and living standards.

Working class spending will not be able to contribute to any resolution of the crisis in the short term when workers are on short hours, facing retrenchment, unemployed, suffering negative equity on their homes, or staring at default on their mortgages. Between Q2 2007 and Q1 2009, household net worth in the US fell by 22% (Zimmerman and Murray, 2009). In Q2 2009, net worth rose by 3.8% on the back of a surge in stock prices, but this is not likely to affect the spending plans of working class households (Associated Press, 2009). The result is obvious in the retail sector where sales in July 2009 were 8.3% lower compared to a year previously. Saving and reducing debt is now the priority for US consumers, not spending, even if this holds back economic recovery – the so-called paradox of thrift.

European workers now face the same situation experienced by US workers for the past 30 years: declining real wages as the jobs crisis begins to hit home. In Europe (Germany, France, Belgium and Holland), the rise in unemployment has been delayed by short-time working and government subsidies to cover part of the wages of workers in hard-hit companies. In April 2009, two million German workers were on short-time. Hundreds of thousands of workers have avoided retrenchments due to such arrangements, and this has maintained working class consumer spending. However, government subsidies will run out in 2010, and economists predict that unemployment in Germany will soar from its current 3.5 million (8.3%) to 4.4 million (more than 10%), when this occurs (Taylor, 2009). Wolfgang Franz, the chairman of Chancellor Merkel's panel of independent economic advisers, told reporters in September 2009 'As much as it hurts me to say it, the worst is yet to come for the labor market' (Anon, 2009a).

In the UK, unemployment is forecast to rise from its current 2.4 million to 3 million by the end of 2009, figures last seen during the early Thatcher years. The chief economist of the Chartered Institute of Personnel and Development in the UK said in August that 'it was far too soon to rule out another avalanche of private sector redundancies later in the year' (Hyland, 2009). In France, where the economy has not plunged as far as its neighbours, this fact did not protect workers' jobs as unemployment rose from 8.9% in Q1 to 9.5% in Q2 2009. Japanese workers, too, face similar pressures. In July 2009, unemployment



reached a record high of 5.7% and average household spending in that month was 2% lower than a year previously (Anon, 2009b). The handouts which were part of many stimulus packages gave a temporary shot in the arm to household spending but the amounts involved were woefully insufficient. Governments rescued the banks but turned a blind eye to the hardship of the working class.

A third possible source of effective demand is world trade. However, with world trade likely to fall by 10% in 2009, there is little potential that the developed countries can reflate on the basis of surging exports. With the US consumers snapping their wallets shut, the Asian economies, which recovered from the 'Asian crisis' of 1997-98 by exporting vast quantities of goods to the USA, will also likely remain subdued.

### **Unsustainable Public Debt and Stimulus Packages**

The inability of business, households or world trade to significantly boost demand at present means that government spending is still playing a major role in preventing the freefall from resuming. This fact lies behind the decision of the meeting of the G20 leaders in September 2009 to maintain the stimulus packages. Pressure from the German and French governments to begin to wind back the stimulus was successfully resisted by the British and American governments well aware that the stock market surge of mid 2009 and apparent stabilization of the financial system were dependent on governments keeping a floor under demand and being ready to step in to prop up banks in difficulty. Any withdrawal of the stimulus would threaten to reveal the underlying lack of solvency amongst hundreds of British and US banks.

Nonetheless, the continued use of the stimulus packages has consequences – they are draining the government purse at an alarming rate. Public debt as a share of GDP in the OECD is forecast to rise from 73% in 2007 to 100% in 2010 (OECD, 2009b). In the US the debt will rise from 63% to 98%, in the Euro area from 71% to 89%, and in the UK from 47% to 89%. Japan, where debt already soared from 64% of GDP in 1991 to 167% in 2007, faces the most significant dangers as its public debt is now forecast to rise to 200% of GDP by 2010 (OECD, 2009b).

The amounts involved are staggering. US debt in early 2009 stood at \$11 trillion: by 2020 it is forecast to rise by another \$9 trillion to \$20 trillion.

A series of problems arise from the escalation of US public debt. First, the spectre of a major financial crunch in the US if overseas governments and financial institutions decide to stop amassing US dollar securities. While such precipitate action is unlikely, short of a viable and stable alternative to the dollar emerging, foreign creditors are likely to demand higher interest rates over time to offset the gradual depreciation of the US dollar that has taken place through 2009. Upward pressure on interest rates may in turn choke off any early recovery as it will exacerbate the housing crisis and prevent any recovery in business investment. The interest bill alone on the debt will eat up an ever increasing proportion of US government funds. A rise in the US debt of \$9 trillion, with higher interest payable down the track in the order of 5%, means that the interest bill on the US debt alone will rise by \$450bn, equivalent to about 3% of GDP. In other words, the US government will have to find another 3% of GDP simply to pay off the additional interest.

Over time, the continuous accumulation of debt and decline in the value of the dollar threatens the US role as the centre of the world financial system and the US dollar as the reserve currency. And while the USA *may* be able to sustain a gigantic debt, such is the global appetite for US dollar assets, the same is not true of any other government. Governments around the world are therefore under pressure to wind back the stimulus packages. That will mean an immense scaling-back in budget spending or tax hikes.

While most sober-minded capitalists and think tanks advise the continuation of high government spending for the foreseeable future, they are all agreed that governments around the world will need to axe social spending down the track. There has been a long-term propaganda campaign by Western capitalist classes about the alleged unsustainability of current systems of pensions and public healthcare. Even before the crisis, US Democrats and Republicans alike were arguing that Medicaid, Medicare and social security (retiree pensions in particular) had to be wound back. President Obama has announced his intention to reduce the budget deficit to no more than 3% within five to ten years, while the Republicans have already announced a plan to cut spending by \$75bn a

year. The re-elected Merkel Government in Germany is threatening severe reductions to government spending, as have both the British Labour and Conservative parties should they win the 2010 general election.

However, winding back public spending presents its own problems. Undertaken quickly and brutally it could spark a fresh collapse as the private sector is incapable of filling the gap left by the withdrawal of Government outlays. Governments are therefore caught in a painful dilemma for which there is no obvious solution.

### **Contradictions in the Chinese Economy**

With the USA, EU and Japan both having fallen into a deep hole in the northern winter of 2008-09 and showing few signs of any substantial real growth since touching bottom, the world's hopes have rested on China to pull the rest of the world out of recession. This is an unlikely outcome. Understanding why means coming to grips with the key components of the Chinese growth of recent decades.<sup>4</sup>

Chinese growth since the early 1980s has been built on its (until recently) unstoppable export machine. Exports have risen from 20% of GDP in 1997 to 40% today. Domestic consumption, by contrast, is only 35-40%. China's 'economic miracle' has been built by suppressing working class consumption and encouraging very high savings rates.<sup>5</sup> Workers' savings deposited in the banking system have furnished a large pool of investible funds for the development of export-related infrastructure. Investment as a proportion of Chinese GDP is about 40%, as against 10-20% generally in the OECD countries.

Keeping a lid on wages through direct repression of trade unions has the added advantage of attracting foreign manufacturers eager to set up

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<sup>4</sup> The following analysis of the Chinese economy from boom to bust to recovery draws extensively from Whitehouse (2009).

<sup>5</sup> With the withdrawal of state-provided healthcare, education and pensions and permanent jobs (the 'iron rice bowl') since the early 1980s, Chinese workers now save nearly half of their incomes to prepare for sickness, unemployment and retirement and to pay for their children's education (Whitehouse, 2009: 29).

operations in what has become the new workshop of the world. Low wages have also reduced demand for imports, enabling the Chinese government to amass huge trade surpluses. State control of the banks and industrial enterprises has allowed the government to stimulate or cool down the economy by manipulating lending and investment more effectively than is possible in the OECD.

Left unchecked, China's export success and enormous trade surpluses would have driven up the yuan and made exports more expensive and imports cheaper. In order to protect the interests of the export-driven economy, the Chinese central bank has bought large quantities of US dollar-denominated assets and printed money to prevent a rapid appreciation of the yuan. The Chinese government now holds \$776bn in US Treasury securities and more than \$2 trillion in foreign currency reserves in total. The fact that the Chinese government has been willing to hold US debts in US dollars has allowed the Federal Reserve to keep domestic interest rates low and thereby contributed to the further expansion of exports to the US market.

China's rapid economic growth gave rise to speculative fever. In 2005-07, there was a rapid rise in the Shanghai stock exchange and the real estate market as newly wealthy enterprises and billionaires splashed their cash. The Shanghai stock market shot up five-fold from mid 2005 until October 2007. House prices followed a similar trend, rising fast through 2006-07. Investment also poured into export industries and export-related infrastructure – roads, ports, airports and so forth. The result in China, as elsewhere in the world economy, was the development of massive excess capacity. Even before the crash, when US demand for Chinese goods was running hot, 75% of Chinese industries were plagued with excess capacity. The Chinese auto industry was capable of turning out twice as many cars as could be absorbed (Bello, 2009).

In late 2007 the stock market bubble burst – the Shanghai exchange fell by 65% over the next 12 months. The property market boom came to earth in early 2008 with house prices forecast to fall by anything between 10% and 30% before the bottom is reached. The construction sector was crippled, and ten million construction workers lost their jobs in 2008 (Whitehouse, 2009). The downturn in world trade in the second half of

2008 was therefore only another heavy blow to an economy that was already staggering. China's export industries fell sharply.

The Chinese government responded quickly in November 2008 with a massive 4 trillion yuan stimulus package which had two elements. One was large-scale government handouts and subsidies to small business to lift domestic consumption in order to provide a market for Chinese businesses. This was largely successful - retail sales were 15% higher in July 2009 than a year previously (Reuters, 2009a). The second was the release of a flood of credit by the state-owned banks to the construction industry for infrastructure development. Investment in urban areas in fixed assets such as roads, rail lines, canals, airports and power plants in the first half of 2009 was up 33% on a year previously (Reuters, 2009a). These initiatives have re-started Chinese industry and growth is back on track for 8% per annum. They have also underpinned strong demand for raw materials and minerals which have helped stave off the worst of the crisis in Australia.

Several contradictions remain, however. First, there are real limits to the degree to which domestic consumption in China can continue to be raised. Government handouts serve a useful purpose in stimulating consumption but, vast though the Chinese government reserves are, the handouts cannot go on forever. The stimulus packages will be exhausted at some stage. Further, the Chinese government is loathe to allow wages to rise significantly. Rising wages in the mid-2000s led to increasing anxiety amongst both local and foreign investors and a preparedness to shift investments to countries with still-lower wages such as Vietnam. Any sustained shift towards an economy based on higher domestic consumption – aside from short-term boosts from state stimuli – is going to be constrained by the fact that higher wages would begin to price Chinese workers out of world markets, assuming there is no significant lift in the skills of the Chinese workforce in the interim. Thus, the kind of structural shift away from a reliance on exports towards domestic consumption is limited by a countervailing force – a tendency by business to shift offshore – that will slow down such a shift. A concern to keep a lid on wages in the context of the crisis is evident in the decisions by the Chinese government in 2008 to rescind a lift in minimum wages

and to defer improvements in labour standards foreshadowed by 2007 labour legislation.

Short of a big surge in strikes capable of pushing up wages substantially, therefore, the Chinese economy is not going to drive the world economy out of its slump. It can help: modest growth in the French, German and Asian economies in Q2 2009 was underpinned by rising exports to China (up by 6.3% in Q2). However, it is nowhere near enough: the Chinese economy is only one-third the size of the US, and the consumer market in the US stands at \$9.5 trillion as against only \$1.5 trillion in China (Batson, 2009). It is the US consumer market that still matters for any expansion of world trade and that is going to be subdued for the indefinite future.

A second significant contradiction in the Chinese economy is that infrastructure development is only exacerbating excess capacity in world and domestic manufacturing. Jobs in construction have bounced back and industrial output was up 12.3% in August 2009 compared to a year previously (Reuters, 2009b). However, most of the expansion is still aimed at the export sector. And, with domestic consumption limited by the factors discussed above, and with exports hemmed in by depressed markets in the USA and Europe, expansion of Chinese export capacity is simply contributing to further excess capacity in world markets and at home. Despite the surge in domestic spending in the first half of 2009 on the back of the stimulus package, the Chinese steel industry was still operating at only 71% capacity in Q2 2009 (Whitehouse, 2009: 30).

The Chinese government's determination to maintain stimulus to the export sector will do nothing to alleviate tension in the world trading system. The tyre industry provides a case study. Between 2004 and 2008 Chinese tyre production capacity rose by 152% and is forecast to rise by another 16% by the end of 2010 (Weisman, 2009). Capacity now far exceeds the ability of the domestic economy to absorb it by a ratio of three to one. The result is that Chinese tyre producers have flooded world markets, with US imports rising from 14.6 million tyres in 2004 to 46 million in 2008 (Weisman, 2009). Under pressure from the United Steelworkers union the Obama administration slapped a 35% tariff on imported Chinese tyres in September. Such initiatives only raise the potential for retaliation.

Third, with the resumption of growth in China, billions of yuan poured back into the share market in the first half of 2009 as Chinese investors looked for quick returns. The Shanghai stock exchange, having plunged in 2008, rose by nearly 80% in the first seven months of the year. In August 2009, however, the stock exchange fell back by 20% before steadying. Speculation, underwritten by bank loans, shifted to property. If property prices tumble, therefore, the heavily leveraged Chinese banks are in big trouble. A prominent Chinese economist wrote in August that the Chinese stock and properties markets were over-valued by 50-100% and were like 'a giant Ponzi scheme' (Chan, 2009).

Further adding to anxiety about the Chinese economy is concern about the integrity of Chinese economic data (Chan, 2009). Simply put, they are subject to extraordinary manipulation. Perhaps even more than the US, the Chinese government has little interest in revealing the true value of assets that Chinese business corporations have accumulated through speculation because the politicians are frequently executives on the relevant boards and have grown rich from the process. Second, provincial premiers frequently report quite unrealistic growth figures to the central government in order to curry favour and promote their own careers. Thus, China reported growth in industrial production of 7.9% in Q2 2009 compared to a year earlier. However, exports were down 22%, power generation dropped by 2.2% and oil demand fell by 3.5%, suggesting that this growth figure is almost certainly exaggerated (Chan, 2009).

A series of economic and political factors therefore limit any potential for China to act as the new locomotive for the world economy.

### **Summary and Prospects**

The fragile 'green shoots' that have appeared in the northern summer of 2009 are no indication that the world economy has escaped the crisis into which it fell in the latter half of 2008. In early September 2009, the UN Conference on Trade and Development attacked the 'green shoots' hypothesis head on. It is worth quoting at length:

But the real economic winter is far from over; tumbling profits in the real economy, previous overinvestment in real estate and rising unemployment will continue to constrain private consumption and investment for the foreseeable future. As the crisis is global, reliance on exports offers no easy way out, since trade is expected to decline by about 11% in real terms and any new trade expansion requires a recovery of consumption and investment somewhere in the world. Given the weakness in macroeconomic fundamentals, an upturn in financial indicators in the first half of 2009 is more likely to signal a temporary rebound from abnormally low levels of prices of financial assets and commodities following a downward overshooting that was as irrational as the previously bullish exuberance. They are not a reflection of strengthened macroeconomic fundamentals but of a restored 'risk appetite' among financial agents. Consequently, they could be reversed at short notice, depending on the pace of recovery and financial market sentiment (UNCTAD, 2009: ii-iii).

UNCTAD is not alone in its sombre perspective. The World Bank said in June 2009: 'While the global economy is likely to begin expanding again in the second half of 2009, the recovery is expected to be subdued as global demand remains depressed, unemployment remains high, and recession-like conditions continue until 2011' (World Bank, 2009). The US Federal Reserve anticipates growth in the second half of 2009 but is not at all confident about this being sustained into 2010. The European Central Bank is predicting a meagre 0.2% growth in the euro area in 2010. The news that the British economy contracted by a further 0.4% in Q3 2009 only added to anxiety about the prospect of a double dip recession (King and Gilmore, 2009).

Regardless of any potential economic recovery, the prognosis for workers is more grim. Following the resumption of growth in output at the end of each American recession since World War II, it has taken steadily longer for employment to return to its pre-recession levels (*Wall Street Journal*, 4 April 2009). The typical lag following the recessions of the 1940s and 1950s was 18-21 months. After the recession of 1974-75, it took 26 months and, following the early 1980s slump, 29 months. Following the 2001 recession, it took a grinding 48 months, or four



years, for employment to recover (*Wall Street Journal*, 4 April 2009). How long will it take for the US to generate net job growth of seven million jobs, the toll thus far? The Director General of the ILO declared in June that '[i]n short, the world is looking at a deep and prolonged jobs crisis' stretching out over the next six to eight years, with employment not recovering fully for four or five years after output starts to recover (ILO, 2009b).

The crash of late 2008 was not simply the result of a financial meltdown but had its roots in a crisis of profitability and excess capacity that has plagued Western economies since the 1970s (Brenner, 2009; Harman, 2009). The devalorisation of capital that has occurred has been huge but still insufficient to restore vitality to the system. This is why the bailouts, stimulus packages and low interest rates can work for a while, but they cannot end the crisis. It is why unemployment is forecast to keep rising. It is possible that the latter half of 2009 going into 2010 may see positive growth, but it will be relatively anaemic and prone to worse shocks.

Like a sick patient suffering multiple diseases, one ailment might be cured to return the patient to apparent health, only for another disease to break out elsewhere on the body economic. This has been the pattern for years. Fixing up the Asian crisis of 1997-98 involved the US stepping in as the buyer of last resort, sucking in imports that only contributed to its long term indebtedness. Lower interest rates in the late 1990s only spurred on the 'tech bubble' of 1998-2000 which brought forth the Enrons, the WorldComs and the eventual crash in 2001.

Still lower interest rates sparked off the US housing boom of 2002-06, which in turn allowed workers to supplement their declining real wages by tapping into the equity on their homes by borrowing more. Working class indebtedness soared, housing prices skyrocketed and the boom ended with the subprime crisis of 2007-08 which shredded house prices, produced millions of foreclosures and brought about the credit crunch in 2008. The stimulus packages are another adrenalin shot in the arm to the sick patient. They may speed things up for a while, but they will not resolve the underlying problem.

Essentially, there are two ways that the systemic crisis in the world economy may be resolved. One is by the capitalist classes undertaking

immense programmes of industrial restructuring and further destruction of capital stock. This means more decades of austerity and attacks on the working class and, potentially, a drive to a fresh inter-imperialist conflagration such as followed the Great Depression of the 1930s. The alternative is the working class solution, of resistance, fight-backs and opening the way to a socialist resolution of the crisis based on democratic planning and production for human need, not the anarchy of the market and the profits of the few which brought us this catastrophe.

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