Global stability rests on sharing the gains
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The surge in the Chinese trade surplus to a record Dollars 14.6bn in July has been followed by the expected pronouncements on its unsustainability and predictions of a destabilising "hard landing" for the US dollar. Yet, the current system of globalised production and liberal financial markets may be more sustainable than analysts maintain.

Capital flows are driven by calculations about risk and return and the rising US import surplus works favourably on both these fronts. US imports of intermediate (as opposed to final) goods and services have risen steadily in the past 15 years and surged recently to more than 25 per cent of all input use in some sectors. These have lowered the cost of production in the US and improved profit margins. At the same time, the development of a wide set of suppliers reduces the risk of production bottlenecks.

All this has raised profits of American companies and attracted capital from abroad. Despite the dotcom bust, inflows of foreign direct investment to the US have remained over Dollars 100bn per year. Most countries still hold the bulk of their reserves in dollars. International payments imbalances, although large, are self-reinforcing. However, the factors generating the imbalances have had consequences for income inequality in the US and China. It is the sustainability of these distributional trends more than the growth in debt to gross domestic product ratios that may determine the outcome of current international financial arrangements.

The increased reliance of US companies on foreign production has reduced costs and also demand for American workers, damping down wage pressures and boosting profit margins. The globalisation of production has been associated with a dramatic increase in corporate profits as a share of US national income, exceeding 12 per cent in the first quarter of 2006 - higher than any quarter since 1966. Wages have stagnated while business productivity growth remains strong.

Similar income distributional considerations are present in China. Low Chinese wages, lagging behind productivity growth, are an important driver of China's export surplus and thus of its foreign reserves accumulation. Chinese workers are subsidising their government in the amount of the interest on China 's holdings of US assets.

How sustainable is this rising inequality? In the US, employment growth has been strong and labour unions weak, limiting resistance to wage stagnation. Adverse wage pressures have been mitigated by low prices resulting from cheap imports and by household borrowing at low interest rates. But healthcare and higher education costs continue to soar and employee pension plans are nearing insolvency. Income disparity and the trade deficit are likely to be big issues in the next congressional and presidential elections.

In China, there has been unrest in the outer provinces, protests of unsafe mining conditions and reports of disgruntled workers leaving the export zones. But the sensitivity in the current situation may stem less from China's working class and more from its rising middle and upper-class, which inevitably will want more say in the political process. Will the government be able to use the earnings on its reserves to placate this group, for example with tax breaks and other preferential treatment? The increasing disparity between rural and urban incomes will also have to be addressed.

If the US unilaterally adjusts its balance of payments - with devaluation or tariffs or deflationary macroeconomic policy - the situation could worsen. American incomes would fall along with exports from emerging markets, heightening inequality on all sides.

Improving the distribution of gains from increased global production interdependence in both the US and China might offer the best way to sustain the system. Gradual democratisation and heightened protection of worker rights in China would ease tension from that country's explosive growth.

In the US, a strengthening of the pension system, a substantial increase in the minimum wage and the provision of universal access to health insurance would protect against the unequal effects of globalisation. More equal distribution of the gains from a liberal global system of trade and finance should also improve the payments imbalances, by raising domestic demand in China and shoring up the balance sheets of households in the US.

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