1 Dropping the Shopping

July 23, 2009

Can America wean itself off consumption?

General Electric has historically been a manufacturer, but in the long boom leading up to the financial crisis it became more like a bank. Half its profit came from its finance arm, GE Capital, which among other things had a lucrative business issuing mortgages and credit cards to American consumers. GE’s chief executive, Jeffrey Immelt, now talks like a man chastened. With GE Capital acting as a drag on the company, he vows that in the future finance will be a smaller part of the company. In its place GE touts its manufacturing and exporting prowess. Mr Immelt boasts of record aircraft engine orders at the Paris Air Show in June, none of them to American airlines.

Like GE, the entire American economy is at an inflection point. For decades, its growth has been led by consumer spending. Thanks to rising asset prices and ever easier access to credit, Americans went on a seemingly unstoppable spending binge, fuelling the global economy as they bought ever bigger houses and filled them with ever more stuff. Consumer spending and residential investment rose from 67% of GDP in 1980 to 75% in 2007 (see chart 1, left-hand side). The household saving rate fell from 10% of disposable income in 1980 to close to zero in 2007; household indebtedness raced from 67% of disposable income to 132%. As Americans spent more than they produced, the country’s current-account balance went from a surplus of 0.4% of GDP in 1980 to a deficit of almost 6% in 2006 (see chart 1, right-hand side).

Economists had hoped that these imbalances would unwind gradually as Americans saved more and the rest of the world spent more. But they had long fretted that the process would end in tears. Most worried about a dollar crash, as investors balked at America’s rising foreign borrowing. Instead the financial crisis felled America’s consumers. The destruction of more than $13 trillion of consumer wealth and the implosion of the shadow banking system, a once plentiful source of credit, has triggered a shift to thrift, which in turn has plunged the economy into its deepest recession in decades. Americans now save more than 5% of their after-tax income, still well below the post-war average but hugely up from only a year ago. The current-account deficit has shrunk dramatically: the IMF projects that it will shrivel to less than 3% of GDP this year and next as Americans spend and invest less.

The collapse in consumption has dramatically changed the composition of America’s economy. A huge increase in private saving has been offset by a leap in the budget deficit. The combination of Barack Obama’s big fiscal stimulus package, as well as the natural consequence of declining tax revenues, means that the federal budget deficit this year is likely to be 13% of GDP, about 12 percentage points more than in 2007. That has cushioned the slump. GE is among those taking advantage. It is aggressively pursuing stimulus-related sales, while tapping federal, state and local incentives. In June the company said that it would create 400 jobs at a plant in Louisville, Kentucky, making a low-energy water heater that is now made in China and that it would hire 1,100 people to staff a software research centre on the site of an auto plant in Van Buren, Michigan. Both investments were helped along by government incentives.

But despite the government’s largesse, America’s recession has been deep and its impact on the rest of the world profound. Though America is still a source of demand for the rest of the world, its waning appetite has been a hefty drag on world economic growth. In the
years before the financial crisis kicked in, American demand contributed to global growth. This year it will subtract from it.

As the boost from fiscal stimulus takes effect there are signs that America’s economy is stabilising. An index of leading indicators compiled by the Conference Board, a research group, rose for the third consecutive month in June. In testimony to Congress on July 21st, Ben Bernanke, the chairman of the Federal Reserve, struck an undeniably upbeat tone about the state of the economy. But the bigger issue—for America and for the world—is where growth will come from in the medium term. The answer is not entirely in America’s hands—in the coming weeks, our series will also look at whether the world’s big surplus economies, China, Germany and Japan, will boost their domestic demand. But as the world’s biggest economy America is the right place to start. Three questions stand out. Can America continue to rely on government stimulus to drive growth? Will the consumer recover? Or can exports take up the slack?

The answer to the first question is “not for ever”. In the short term, policymakers are committed to using a mixture of fiscal stimulus and aggressive monetary policy to hasten the end of the recession and prevent inflation from turning into deflation. But the contribution of the stimulus is due to start ebbing in 2010. The lesson of Japan in the 1990s is that the after-effects of a bubble suppress demand for longer than most expect, necessitating extended government stimulus. Unlike Japan, though, America is already in hock to the foreigners. Mohamed El-Erian of Pimco, a fund manager, predicts that policymakers will be reluctant to stimulate any further for fear of feeding suspicions that America will inflate away its debts, which could push long-term interest rates much higher. Even if they do not withdraw the stimulus next year, they must at some point if the federal debt, projected to double to 82% of GDP by 2019, is to stop rising.

The prospect of a withdrawal of government support need not spell disaster. As America looked forward to the end of the second world war, policymakers were deeply anxious that as war spending shrank, the economy would slip back into 1930s-like stagnation. “All alike expect and fear a post-war collapse,” Alvin Hansen of Harvard University, a leading economist of the time, wrote in 1942. Yet the collapse never came. Thanks to rising productivity and rapid recovery in Europe and Japan, the post-war years witnessed strong, balanced growth. From 1946 until 1980, American households saved 8-10% of their disposable income and the country usually ran small trade surpluses.

An historic challenge

Perhaps productivity can accelerate again, boosting incomes enough to support robust spending as well as more saving. But an obvious difference from the post-war period is the need for American consumers to reduce their debts. Richard Berner of Morgan Stanley notes that in the past decade the proportion of income that American households devoted to servicing debt rose from 12% to 14%. He calculates that it would have risen to only around 12.5% but for a dramatic loosening of lending standards during the recent bubble. He thinks the ratio will revert to around 12% through a combination of lower interest rates, debt repayments and write-offs. That can be done, he says, with consumer spending growing at just over 2% a year, still far below its average of 3.4% from 1993 to 2007.

The implication is that demand from abroad must take the place of a splurging domestic consumer and a free-spending government. As Larry Summers, Mr Obama’s chief economic adviser, said on July 17th: “The rebuilt American economy must be more export-oriented and less consumption-oriented.”

Take California, where the consumption and housing bubbles were especially pronounced. The shortage of land on the coasts drove many first-time homebuyers inland, fuelling a huge building boom. According to Jerry Nickelsburg of the Anderson Forecast at the University of California, Los Angeles, home-building permits tripled between the 1990s and 2005. The growth of new housing developments triggered a boom in new retail stores, lured by local government incentives. Meanwhile, America’s ravenous appetite for imports from Asia fuelled business at the ports of Long Beach, Los Angeles and Oakland and their supporting infrastructure of railroads, transport and warehouses.

California’s disproportionate exposure to the boom explains why its bust has been especially painful. Mr Nickelsburg says home-building permits have plunged by 85% since 2005 and that the value of new retail- construction permits has fallen by half. Import volumes have dropped sharply. Most big subprime lenders have gone bankrupt or left the business.

The first glimmers of an export-led revival are apparent. The state’s manufacturing employment has shrunk by less than in most of the big manufacturing states, reflecting less dependence on Carmakers and greater ex-
posure to Asia. The seasonally adjusted number of containers loaded at its ports for export, many with agricultural products and other raw materials, has risen from the lows of earlier this year.

But it is one thing for exports to grow (and imports to fall) but another entirely for trade to compensate for the retrenchment of the much larger consumer sector. A cheaper currency may help. The trade deficit narrowed sharply in the late 1980s with the help of a dramatic fall in the dollar against the currencies of America’s largest trading partners. The dollar has come down considerably since 2002 but has rallied over the past 12 months as investors have repatriated money from abroad. Its decline is likely to resume but its contribution to rebalanced growth will be constrained if China does not let the yuan appreciate against the dollar.

Turning circle

Nor is it clear how quickly America can shift resources into tradable products. Its economy is adept at moving workers and capital from dying to growing industries. But the scale of the adaptation needed now is daunting. Robert DiClemente, an economist at Citigroup, estimates that credit-sensitive industries—housing, finance and cars—have shed 2m jobs, or one-third of all those lost, since the recession began (see chart 2). It is not clear how quickly mortgage brokers and structured-finance whizzes can retrain in more productive industries. The fact that so many homeowners are sunk in negative equity will also constrain mobility.

The American economy is like a supertanker that, even in calm waters, changes direction very slowly. It is now being forced to do so in a gale. With the help of still sturdy growth in emerging markets America should be able to reorient itself. But come what may, changing direction means losing speed. On the demand side foreign spending is unlikely to compensate for the freewheeling American consumer. On the supply side investment has slumped and will take time to right its course. Pimco’s Mr El-Erian reckons that the transition from consump-

2 The Spend Is Nigh

July 30, 2009

Can China reduce its trade surplus by consuming more?

A rebalanced global economy requires America to consume less and save more. That means the world’s three big surplus economies—China, Germany and Japan—will have to save less and spend more. None is under more scrutiny than China, whose vast current-account surplus has been fingered by some as the ultimate cause of the financial crisis. The case against China is exaggerated but a surplus of more than $400 billion in 2008, or 10% of GDP, was clearly too big. Can China right its trade imbalances, and if so, how will it achieve rapid growth in future?

The good news is that the surplus is already shrinking. The strong rebound in China’s economy in the second quarter—pushing GDP 7.9% higher than a year ago—came entirely from domestic demand. This sucked in more imports, while exports continued to slump. China’s merchandise trade surplus narrowed to $35 billion in the same quarter, 40% down on a year earlier. Yu Song and Helen Qiao of Goldman Sachs calculate that the decline is even more impressive in real terms (adjusting for changes in export and import prices), with the surplus shrinking to less than one-third of its level a year ago (see chart 1). They even suggest that a monthly trade deficit is possible within the next year.

Another way to look at the huge swing in China’s trade is that net exports (exports minus imports) contributed 2.6 percentage points of the country’s GDP
growth in 2007, but shaved almost three points off its growth in the first half of this year.

Most economists think that China’s trade surplus will remain large. The jump in imports in the second quarter included heavy stockpiling of commodities, which will not last; copper imports, for example, were 150% higher than a year ago. Yet the underlying surplus is clearly shrinking. Paul Cavey of Macquarie Securities forecasts that China’s current-account surplus will fall to under 6% of GDP this year and 4% in 2010, down from a peak of 11% in 2007. Exports amounted to 35% of GDP in 2007; this year, reckons Mr Cavey, that ratio will drop to 24.5%.

On the surface, therefore, China is fulfilling the long-standing demand of Western governments that it shift its engine of growth from exports to domestic demand. Thanks to the biggest fiscal stimulus and loosening of credit of any large economy, China’s real domestic demand is likely to grow by at least 10% this year. In fact, the popular perception that China has always relied on export-led growth is rather misleading. Its current-account surplus did soar from 2005 onwards but until then was rather modest. And over the past ten years net exports accounted, on average, for only one-tenth of its growth.

The problem is more that the mix of domestic demand between consumption and investment is unbalanced, and becoming even more so. In 2008 private consumption accounted for only 35% of GDP, down from 49% in 1990 (see chart 2). By contrast, investment had risen from 35% to 44% of GDP. This year the bulk of the government’s stimulus is going into infrastructure, further swelling investment’s share. Chinese capital spending could exceed that in America for the first time, while its consumer spending will be only one-sixth as large. This is China’s most glaring economic imbalance.

Spending lots of money on building railways, roads and power grids is the most effective way for the government to prop up demand in the short term—especially since China, as a poor country, needs better infrastructure. However, the pace of investment is unsustainable. Even before this year’s infrastructure boom capital spending was too great, causing many economists to worry about excess capacity and the risk that bank loans could sour.

China deserves credit for the speed with which it responded to the global downturn. Now it needs to focus on structural reforms not just to keep domestic demand growing strongly and to reduce its trade surplus further, but also to derive more of its growth from consumption and less from investment.

Before exploring how China can do so, it is important first to clear up a misunderstanding. It is often argued that China runs a current-account surplus because its consumer spending has been sluggish. On the contrary, China has the world’s fastest-growing consumer market, increasing by 8% a year in real terms in the past decade. Retail sales have leapt by 17% in real terms in the past 12 months, although this figure may be inflated by government purchases. Even so, China’s consumer spending has grown more slowly than the overall economy. As a result consumption as a share of GDP has fallen and is extremely low by international standards: only 35%, compared with 50-60% in most other Asian economies and 70% in America.

Economists disagree about the main reason why the consumption ratio has fallen—and hence about the best way to lift it. The most popular explanation is that Chinese households have been saving a bigger slice of their income because of an inadequate social safety net. They have squirreled away more money to cover the future cost of health care, education and pensions. According to Eswar Prasad, an economist at Cornell University, the saving rate of urban households has jumped from 20% to 28% of their disposable income over the past decade. After exploring all the possible causes, he concludes that uncertainty about the private burden of health care and education is indeed the main culprit. The effect has been worsened by an undeveloped financial system, making it hard for households to borrow.
The Beijing government is acting: it doubled spending on health care, education and social security between 2005 and 2008. But the total amount remains low at only 6% of GDP, compared with an average of around 25% in OECD countries. This year the government has increased pensions coverage and payments to low-income households. It has also pledged to provide basic health care for 90% of the population by 2011, although the new spending appears to be less than 0.5% of GDP each year. If such measures ease households’ worries about future health care, they could encourage them to save less. But it will take years for them to have much effect on consumer behaviour.

Slicing up saving

More to the point, an inadequate welfare state does not fully explain why consumption has fallen as a share of GDP. The first niggle is that most workers lost their state-provided health care and education almost a decade ago, after the reform of state-owned firms, so this cannot really explain why saving has continued to rise more recently. Louis Kuijs, an economist at the World Bank in Beijing, suggests that the extra saving may owe as much to greater income inequality as to the lack of a welfare state. Rich people save a lot more and their numbers have increased.

A second flaw in the thesis is that although urban households have been saving more, rural households have become less thrifty over the past decade. As a result China’s average household-saving rate has risen more modestly. Mr Kuijs calculates that total household saving has risen from 21% of GDP in 1998 to 24% in 2008. Households accounted for only one-fifth of the increase in total domestic saving over the period. Most of the increase in saving came from companies (see chart 3).

This matters for two reasons. First, if anyone saves too much, it is companies, not households. Second, you need to look elsewhere for the cause of China’s falling consumption ratio. The drop in consumer spending as a share of GDP over the past decade has been almost four times larger than the rise in household saving.

The more important reason why consumption has fallen is that the share of national income going to households (as wages and investment income) has fallen, while the share of profits has risen. Workers’ share of the cake has dwindled because China’s rapid growth has generated surprisingly few jobs. Growth has been capital-intensive, focusing on heavy industries such as steel rather than more labour-intensive services. Profits (the return to capital) have outpaced wage income.

Capital-intensive production has been encouraged by low interest rates and by the fact that most state-owned firms do not pay any dividends, allowing them to reinvest all their profits. The government has also favoured manufacturing over services by holding down the exchange rate as well as by suppressing the prices of inputs such as land and energy.

Simply urging households to spend a bigger slice of their income will not be enough to shift China’s growth towards consumption. Beefing up the welfare state is important but policy also needs to focus on how to lift household income and reduce corporate saving, says Mr Kuijs. Making growth more labour-intensive will require lots of difficult reforms. China needs financial-sector liberalisation to lift the cost of capital for state-owned companies and improve access to credit for private ones, especially in services. Higher deposit rates would also boost household income. Distortions in the tax system which favour manufacturing and barriers to private-sector participation in some service industries should be scrapped. State-owned firms ought to be forced to pay bigger dividends. The prices of subsidised industrial inputs should be raised. Land reform and the removal of restrictions on migration from rural to urban areas would also help to lift incomes and thus consumption.

China has barely started on these important reforms. That may be because they involve much harder political decisions than creating a welfare state. They require the government to loosen its control over the economy, something which Beijing will do slowly and reluctantly.

Last but not least, China needs to allow its exchange rate to rise. This would lift consumers’ real purchasing power, discourage excessive investment in manufacturing
and help to reduce the trade deficit further. It would also alleviate the risk of a protectionist backlash abroad. From July 2005 (when China abandoned its dollar peg) to February 2009, the yuan rose by 28% in real tradeweighted terms, according to the Bank for International Settlements. But alarmed by the collapse of exports, China has virtually reppegged the yuan to the dollar over the past 12 months. As the greenback fell this year, it dragged the yuan down with it. Since February the yuan’s real trade-weighted value has lost 8%.

Economists disagree about the extent to which the yuan is undervalued. In the IMF’s “Article IV” assessment of China, published on July 22nd, officials were split over whether the currency was “substantially undervalued”. Morris Goldstein and Nicholas Lardy, of the Peterson Institute for International Economics, have done some of the most extensive work on China’s exchange rate. In a new study, they estimate that the yuan is undervalued by 15–25%, based on the adjustment needed to eliminate the current-account surplus.

The American government has softened its demands for revaluation, largely because it needs China to keep buying Treasury bonds to fund its own stimulus spending. At the Strategic and Economic Dialogue meeting between American and Chinese officials on July 27th and 28th in Washington, DC, the yuan’s exchange rate was barely discussed. However, the case for appreciation remains strong.

China’s recent efforts to boost domestic spending have helped to maintain robust growth and reduce its trade surplus. But excessive levels of investment are not a recipe for sustained rapid growth. Unless it is prepared to embrace difficult structural reforms and to allow the yuan to climb, China’s commitment to rebalancing will remain half-hearted. In the long run that will be bad news for China itself as well as for the rest of the world.

3  The Lives of Others

August 6, 2009

Can Germany wean itself from its export dependence?

There was a time not so long ago when European policymakers believed trade imbalances were only a problem for America and China. For much of 2008, a stock phrase in the press statement agreed each month by the European Central Bank’s rate-setters was “the euro area does not suffer from major imbalances.” As the year wore on, the claim was repeated but seemed more and more desperate, as if it were a spell to ward off recession. It was only when the collapse of Lehman Brothers in September sparked a global slump that the formulation was quietly dropped.

In a narrow sense the claim was true. Until the crisis struck, the euro area’s current account was roughly in balance. That contrasted with America, where a spending boom and falling savings drove the current-account deficit as high as 6% of GDP in 2006. But Europe looked steadier only because Germany’s huge trade surplus offset deficits elsewhere—notably in Spain but also in France, Greece, Italy and Portugal.

These imbalances were not trifling. In 2007 Spain had the largest current-account deficit in the world outside America. The surplus chalked up by Germany that year, at $263 billion, was second only to China’s hoard of $372 billion. Germany’s saving glut allowed others to spend freely and to run up large debts. Its economy benefited from strong export sales to other euro-zone countries, as well as to America and Britain. The common currency allowed imbalances to grow unchecked by fears of an exchange-rate crisis.

But the skewed pattern of demand only made recession worse when it came. The biggest slumps in demand were in Spain and Ireland, where growth had been consumer-led. The impact on output was felt most in Germany, where a collapse in exports and investment drove GDP down by 7% from its peak. The question now, with its main customers pulling back, is whether Germany can kick its export addiction and encourage more demand at home.

A rebalancing of world demand requires high-savers, such as China and Germany, to spend more and run smaller trade surpluses so that the trade deficits of countries such as America and Spain can narrow as savings are rebuilt. Recession has forced that adjustment to begin in the most painful way. Germany’s current-account surplus shrank dramatically, to 3.4% of GDP, in the three months to the end of March, from 6.6% of GDP during 2008 (see chart 1). The change in its external balance has made Germany the world economy’s main shock absorber, says Hans-Werner Sinn of the Ifo Institute for Economic Research in Munich.

Much of the adjustment reflects a collapse in exports. Germany specialises in machinery and durable goods, purchases that businesses and consumers will put off when times are uncertain. It also reflects the resilience of domestic demand. German consumer spending has been broadly flat. That would count as a boom in many
places where consumers are cutting back.

Fiscal policy has been a stabilising force, too. Germany’s budget deficit should rise from around zero to 4% of GDP this year, and to 6% in 2010. Although it was a late convert to the need to do more, Germany’s stimulus has worked well. Consumers have kept up their spending because most have held on to their jobs. A government scheme that allows firms to put underused employees on short-time working, and which subsidises their pay, has stopped unemployment rising sharply. Around 1.4m workers are on the short-time register, many of them in the depressed car and capital-goods industries. Cash incentives from government for older cars that are traded in for new ones have helped boost sales.

The short-time arrangements mean that workers stay in employment and keep their skills fresh. Firms are not panicked into laying off workers they might otherwise have to hire back again at great cost. “There is a certain accord with government to keep our core workforce intact for as long as possible,” says Matthias Wissmann of the German Association of the Automotive Industry (VDA).

The drawback of the short-time working scheme is that it prevents a broader economic restructuring. When Spain’s fiscal-stimulus package provided funds to build low-cost housing, it was criticised for spurring more construction in a country that had already seen too much. Germany’s schemes to prop up demand for cars and car workers have the same weakness. They fossilise an industrial structure that needs to change.

Officials see these initiatives as a “bridge” over global recession and they are candid about what they hope is on the other side: a return to export-led growth. Some point out that Germany’s economy cannot quickly change its orientation towards domestic demand. It has a comparative advantage in producing specialist goods that require a global market. “You cannot put power plants in the supermarket,” notes one German economist. There is also widespread concern about the long-term costs of today’s fiscal props for a rapidly ageing economy. Fingers are crossed that foreign demand will revive quickly so that Germany can get back to a balanced budget soon. Fine, except that it was Germany’s export dependency and manufacturing bent that made its economy so vulnerable in the first place.

The presumption that what is good for exports is good for the economy partly explains why consumer spending in Germany has historically been weak. Its typical response to a faltering economy is to trim manufacturing costs, including wages, in order to keep exports keenly priced against other countries. That was the path taken in the early 1970s, when the D-mark rose after the collapse of the Bretton Woods system of fixed exchange rates. It was followed again after the 1990s when Germany’s reunification boom and devaluations by some trading partners pushed up its relative wage costs.

The wage discipline was remarkable. German pay was more or less frozen for a decade from the mid-1990s, at a time when it was rising quickly in the rest of Europe. That wage restraint tilted demand in favour of exports and away from consumption. The share of employee pay in GDP drifted steadily downward until the eve of recession last year (see chart 2). So even as exports boomed and jobs were created, sluggish wages meant the gains from national income growth went mostly to profits. Consumer spending suffered, falling to a low of 56% of GDP—well below America’s 70%. The increase in the rate of value-added tax (VAT), from 16% to 19%, at the start of 2007 was a further check on spending. It says something that the increase was sold as a way to boost competitiveness (VAT is a tax that hurts consumption but not exports).

This tale of export fetishism tells us how Germany looks abroad for demand to kick-start its recoveries and explains why its trade balance rises in the early phase of the cycle. But it cannot fully account for the vast and enduring current-account surpluses that Germany piled up year after year. They also reflect a persistent excess of domestic saving over domestic investment. The share of income that households put aside has been broadly
stable for years but the investment share in GDP has declined (see chart 3). That is partly because Germany’s mature export industries do not have great scope or appetite to expand capacity. It is also because capital is not finding its way to new ventures.

Some analysts believe that Germany’s deep-rooted preference for equality in pay lies behind both its bent for export-led growth and the seemingly endless surpluses. In this view, a welfare policy designed to maintain a narrow gap between the best- and worst-paid employees has limited the earnings of the most skilled workers across all sectors, tempting many of them abroad. This “wage compression” has also stunted the emergence of a low-wage service sector that could cater to the home market. Wage floors prop up the pay of unskilled workers and make services expensive to supply. If personal services were on tap cheaply, consumers might spend more. Since investment in service industries is less attractive the pool of domestic savings leaks abroad.

Whenever firms are reluctant to invest, economists are quick to blame “inflexible” product and job markets. It is hard to start a business in Germany: it was ranked 102nd out of 181 countries on that criterion in the World Bank’s 2009 Doing Business survey. Such regulatory barriers stop the economy’s broader industrial structure from changing. Yet within manufacturing, businesses are flexible in their use of labour and in their control of costs. Germany’s small capital-goods firms are famously nimble. If exporters were too rigid, they would not be quite so successful.

That suggests the standard wish-list of reforms might not make the economy any less dependent on exports and manufacturing. Germany’s export addiction has deep roots. There is a wariness about services, particularly personal services, and a pride in being the world’s biggest exporter. “Why does it take so long to start a company? Why are there so few links between universities and business? We have been wedded to the export model for so long we have ceased to look for alternatives,” says Thomas Mayer of Deutsche Bank.

Germany may never again run as large a current-account surplus as it did before the crisis, if only because many of its main export markets will not easily regain their former buoyancy. German makers of plant and machinery may feel they have a decent chance of bouncing back, thanks to China’s state-sponsored recovery. Durable-goods manufacturers (especially carmakers) will find the going far tougher, as consumers in America, Britain and Spain struggle. If foreign demand does not fully return, jobs will go once short-time working schemes expire. The government will have to keep supporting the economy while the private sector restructures.

Cars for clunkers

A shift from export dependency to an economy that serves its own consumers better would be painful but would be good for Germany, and the world, in the longer run. Its big saving surpluses required big deficits somewhere else; the deeper Germany’s customers fell into debt, the less their IOUs were worth. German banks ended up with toxic American assets because they had excess savings to recycle. When carmakers reached capacity limits at home, they used cash piles to make poor acquisitions abroad (Daimler and Chrysler; BMW and Rover).

“It made no sense for Germany to sell Porsches for Lehman certificates,” says Ifo’s Mr Sinn. Those loaned funds could instead have been used to finance new ventures at home. Soon many Germans will reach retirement age; they will need a richer array of services than is on offer now. As some export industries shrink, new service industries will be needed to create jobs. That may even lift Germany’s long-term growth rate. The export model left Germany at the mercy of changes in global demand. Yet there was no real growth dividend to compensate for that exposure. Growth in GDP per person in the past decade has been slower than in France and well below that in Britain or America.

There is a danger that Germany takes the wrong lesson from the crisis. It could decide the episode only shows the folly of relying on finance and services to drive growth, as America and Britain have. It could simply reinforce its long-standing export bias. But thoughtful Germans may conclude that a crisis that has created such a burden for future taxpayers stems partly from the ill use of their own savings. They may well end up wishing they had spent the money on themselves.
Japan’s long-standing inability to rebalance its economy is bad for the world and even worse for its own people.

No citizens in the rich world take as few holidays as the Japanese. No wonder. This week, as millions left the cities for an annual pilgrimage to villages where they venerate the souls of their ancestors, many were likely to be stuck in 40-mile traffic jams on oven-like expressways, cursing the midsummer heat.

Such misery is common during the Buddhist festival of Obon, but it is worse this year. One of the government’s aggressive measures to alleviate the economic crisis is to encourage people to spend money on hotels, transport cafés and other forms of leisure. To do that, it has slashed the cost of toll roads to almost one-tenth of their normal level, attracting yet more people on to fume-choked roads.

This is not the first time Japan’s leaders have tried to emphasise the fun side of life to strengthen Japan’s domestic economy and leave it less vulnerable to the vagaries of world trade. In 1986, when Japan’s bulging current-account surplus was a huge source of tension with America, the Maekawa report, written by a panel of Japanese experts, preached the virtues of more time off as a means for workaholics to let their hair down and spend, spend, spend.

It never happened. Instead, what Japan gave the world in the late 1980s was a lesson in how tricky it is to rebalance economies. The country first mollified America and evened out its trade books by raising the value of the yen. But as the dollar slid, it reversed course and cut interest rates, which boosted spending on everything from golf-club memberships at home to splashy buildings in Manhattan. Cheaper credit had the effect of stoking the vast stockmarket and land bubble that popped with disastrous consequences in the 1990s and beyond.

Fast forward to this decade and Japan’s current-account surplus was higher than ever, reaching a record 4.8% of GDP in 2007 (see chart 1). That is because the impact of foreign trade on the growth of the economy is still much larger than in many other, more open economies. Export growth increased from 4% a year in the decade beginning in 1992 to nearly 10% annually from 2002-07. OECD figures show that the contribution of foreign trade to GDP growth during those years was as high in Japan as in Germany. Some of the bumper profits of large exporters selling Lexus cars, video-game consoles and flat-screen TVs to Westerners during the cheap-credit era were also pumped back into building factories and investing in new technology at home, which further boosted growth. According to OECD estimates, export industries generated about a third of annual output during the pre-crisis years.

A current-account surplus that has persisted for almost all of the past three decades, whether the yen was strong or weak, suggests a structural issue rather than a cyclical one. A recent report on Asian imbalances by Morgan Stanley shows that throughout the boom-and-bust periods since the early 1980s, investment has consistently fallen short of savings (see chart 2). Households, which used to be Japan’s greatest hoarders, put less aside in the years before the financial crisis as a combination of low wage-growth and an ageing population took its toll: the household-saving rate fell from above 10% in the 1990s to about 2.2% in 2007. But the country continued to spend less than it earned because exporters squirreled a chunk of their profits away.

A combination of factors kept domestic demand below par. Japanese workers benefited less from the recent export boom than they had previously: the OECD says their share of GDP fell from a peak of 73% in 1999 to 65% in 2007. Japan’s ugly demography, with a shrinking working-age population and a growing grey-haired one, helped the downward pressure on wages. More high-paid workers were retiring and being replaced by lower-paid youngsters, which dragged down overall wages. The retirees did not spend as freely as they might because of uncertainty over the government’s commitment to state pensions.

Two other features in the economy also held down
pay, and hence consumer spending. First, Japan suffers from a glaring gap between large firms, which are highly profitable, and small ones. According to the IMF the latter continue to struggle with the legacy of Japan’s 1990s debt crisis. Although they provide about 70% of jobs in Japan, they have meagre profits from which to fund wage increases (see chart 3).

Second, within the manufacturing industry, there is a big disparity between unionised workers, who enjoy high pay, bonuses and job security, and “non-regular” workers. In the years before the crisis the latter grew to account for about one-third of the workforce, as firms sought to increase flexibility in the face of competition from low-wage rivals in Asia. That shift led wages to fall in 2007, even though the economy was near full employment. These wage pressures meant that the country’s five-year growth spurt before the crisis—the longest in Japan’s post-war history—had very little impact on the average household. Over the five years to 2007 real private consumption grew by 1.1% a year, about the same level as during the “lost decade” of the 1990s. That was higher than in Germany, but far lower than in America, where consumer spending grew almost three times as fast.

Skew etiquette

Why is Japan such a lopsided economy? Explanations for why the Japanese are serial exporters include government support of trade and industry (the links between big business, the ruling party and civil servants are known as the “iron triangle”), a strong sense of shared mission among firms’ employees, and an obsession with detail that enables Japan to manufacture high-quality goods.

The aversion to spending is also deep-rooted. Richard Koo, chief economist at the Nomura Research Institute, believes that domestic demand is stunted by a respect for hard work, which chains people to their desks rather than unleashing them to enjoy themselves in shops or on holiday. A further structural problem is the way the Japanese save in order to rebuild their homes every 15 years or so. This is a legacy of centuries of earthquakes and fires in Japan, but it prevents an American-style culture of lavish home improvements.

There is also a reluctance to borrow. Consumers rarely shift credit-card debts from one card to another. Small businesses are still paying off loans from the previous crisis; banks are shy of lending because of the current one. Katsuyuki Hasegawa, chief market economist at Mizuho Research Institute, says the anti-debt culture is deeply entrenched. “People don’t like borrowing. They just like paying back.”

The crisis that has hit Japan since 2008, and which is expected to generate a decline of at least 5% of GDP this year, is only likely to make people more cautious. The export collapse that first hit Toyota and other big carmakers quickly spread down the supply chain to the domestic economy. As profits dived, so did business investment. Unemployment jumped from 3.8% in October to 5.4% in June—not as high as in America and Europe, admittedly, but accompanied nonetheless by yet another onslaught on wages. In this context the sharp narrowing of the current-account surplus to 1.4% of GDP in the first quarter is nothing to celebrate.

In the short term Japan’s path out of the crisis is familiar. The government has stepped in with one of the most aggressive fiscal-stimulus packages in the rich world. Hopes are pinned on a pick-up in exports to China as it rebounds. On August 17th Japan is expected to report its first increase in quarterly GDP in five quarters.

But in the long term, rebalancing the economy is the best way to ensure higher growth. This is particularly important to Japan because it is saddled with the highest public-debt-to-GDP ratio in the rich world, at about 180%, the legacy of years of propping up a moribund economy.

The debt will rise even higher as spending on the elderly increases, raising the possibility of a fiscal crisis if ever the Japanese grow tired of funding their government’s borrowing habit. (So far Japanese bond yields have risen less than in other crisis-hit countries such as America and Britain, partly because most of the debt is held at home, but the IMF warns that Japan would be very vulnerable if there were a loss of confidence in the sustainability of public debt.)

Eventually taxes will have to rise to reduce these debts. But the best way to ensure that does not throw the economy into another slump is to foster a more even-keeled recovery, with services playing a bigger part. Such businesses—retailers, builders, hairdressers and the like—are so inefficient that, according to the OECD, they have dragged down labour-productivity growth in the country as a whole from 4% in the boom years of
1976–89 to just 2% between 1999 and 2004. Only broth-
ells appear to be doing well. A recent report from the
Bank of Japan showed their numbers have mushroomed
in the otherwise depressed northern city of Sapporo.
Nearby eateries, by contrast, have shut down in droves.

The OECD last year set out to explain why service
industries were so poor in Japan. Research and devel-
opment (R&D) in services was minuscule—one-quarter
the level of America, as a share of total R&D. Com-
petition among firms is stifled, with very high levels of
concentration and high barriers to new entrants. Infor-
mation technology in services is poor, an extraordinary
weakness in such a tech-savvy country. Multinationals,
meanwhile, find it unusually difficult to set up Japanese
affiliates in fields such as telecoms and travel because of
investment restrictions and regulatory barriers. But the
outsiders’ record, by and large, should encourage Japan
to deregulate further: the OECD found that productiv-
ity growth among those foreign firms that did enter the
market was 1.8 times the national average.

With the working-age population likely to shrink by
9% during the next decade, according to government
estimates, the quest for higher productivity will become
pressing. That search has costs of its own: restructuring
would require job losses in some enterprises. But an
unshackled service industry would eventually generate
wage gains. Without one, overall living standards will
suffer.

One of the most sensible ways to achieve higher pro-
ductivity would be to slash the forest of regulations that
surround service industries, protecting them from com-
petition in the name of quality control. Farming could
be liberalised, as could heavily protected bits of the econ-
omy such as energy, transport, health care and educa-
tion. Policies to encourage investment, both foreign and
domestic, would help.

**Vote sinners**

But in the run-up to general elections on August 30th, a
poll that may mark the end of 54 years of almost unbro-