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【Book Review】

明日は雨、人は泥棒
Economic Forecasting After Lehman

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Stephen D. King. 2013. *When the Money Runs Out: The End of Western Affluence*. New Haven, CT., Yale University Press. Books. Pp. xxi, 213. ISBN 978 1 846 14484 4 (hardback).

Michael Pettis. 2013. *The Great Rebalancing: Trade, Conflict and the Perilous Road Ahead for the World Economy*. Princeton, N.J., Princeton University Press. Pp. ix, 219. ISBN 978 0 300 19795 2 (paperback).

Ist das denn meine Straße? O Seher, sprich, wohin?

The casualties of the Great Recession that began in 2007-2008 are already too many, and too anonymous, to count, and fresh ones continue to present themselves at A&E all the time. Chief among the victims of this seemingly endless slow-motion crash are those who have lost jobs and homes, and those who live in fear that they may yet join their ranks — and, as with any seeming accident, it is not easy for many of them to understand why they in particular should have been singled out for suffering. But those who go in search of justice can at least console themselves that some among the bystanders, most notably perhaps members of the economics profession, have not escaped entirely unscathed either. Their wounds, it is true, are only superficial, consisting mostly of lacerations to the self-esteem, not many of which go very deep. Indeed the reputational cuts and abrasions would in all probability have healed completely by now, were it not for ignorant non-specialists who insist on rubbing salt into the wounds by adding insult to injury. For economists who ply their trade in the worlds of business, administration and academia have found their track record and pretensions under scrutiny in the court of public opinion as seldom before. In aggregate the charges against them imply a failure, as dismal as their discipline, to grasp the nature of the reality, past and present, confronting them; they have been arraigned for negligence, complicity and incompetence, accused (with a few honourable exceptions) not merely of being caught entirely unawares by the swift onset and magnitude of the crisis initiated by the subprime collapse, but also of actually abetting its irruption and of having deplorably little to offer in the way of remedies to atone for their offences.

The suspicion that the experts, especially at the highest levels, had been culpably blind did not take long to infect the public mood, and the journalistic foxhounds were soon on the trail; one of them was noting as early as August 2009 how 'According to a recent Gallup poll, Ben Bernanke, chairman of the US Federal Reserve, is held in lower regard among Americans than the Internal Revenue Service…[while] the Bank [of England]'s credibility and authority have been greatly undermined by the events of the past two years' (Warner, 2009). But other, lesser mortals also found themselves being pursued as quarry; academics, for instance, whose ivory towers were neither sufficiently remote nor lofty enough to keep them from being brought to bay by the cries for soul-searching and repentance. Thus in a piece that attracted a wide readership and plenty of controversy, the Nobel Laureate, Paul Krugman, was moved to ask openly, 'How Did Economists Get It So Wrong?' (Krugman, 2009). Nor has the angst dissipated with the passing of time; in February 2012 the U.K.'s Government Economic Service and the Bank of England hosted a conference on the state of economics, the proceedings of which have been published, entitled *What's the Use of Economics?* (Coyle, 2012); a question to which the answer is, on first blush, even less self-evident than the truth that all men are created equal.

It would, nonetheless, have been completely unrealistic to expect economists to conclude from the recent debacle that their studies are an expensive waste of time and resources. So it is no surprise to find that, despite his apparent tone of contrition, Professor Krugman was also at pains in 2009 to exonerate, in part at any rate, neo-Keynesians like himself who, he claimed, had at least the makings of an answer to the Great Recession. In fact, amid the wrack, he could even discern a professional silver lining to the recessionary clouds, for the onset of the storm represented a massive reality check for 'freshwater economists', 'efficient market advocates', and those who seemed intent on cleaving to 'neoclassicism, despite its utter failure to make sense of the greatest economic crisis in three generations'. The deluge of events may have done untold damage in the rest of the world, but it had at least swept the graveyard of economics clear enough to permit the resurrection of Keynesianism, which 'remains the best framework we have for making sense of recessions and depressions' (Krugman, 2009). Salvation could be sought, too, in the rapidly developing field of behavioural economics, a growth area attractive to other economists seeking oblivion for the past and a fresh start; Diane Coyle, for instance, lauds the 'successes of applied microeconomics' and laments the slowness with which these are penetrating the undergraduate curriculum in the U.K. (Coyle, 2012, p. x).

As it turns out, though, Professor Krugman had got rather ahead of himself in 2009, for consensus about the way forward in fact remains as far off as ever, especially in the macroeconomic arena, where the protagonists of austerity and stimulus continue to hack away at one another even as the Great Recession continues its slow torture of the world all the while. Perhaps this goes some way to explaining why pessimism is now on the rise; even Professor Krugman, it appears, is no longer immune to attacks of the blues.

> We had what felt like an epic intellectual debate over austerity economics, which ended, insofar as such debates ever end, with a stunning victory for the anti-austerity side — and hardly anything changed in the real world. Meanwhile, the pain caucus has found a new target, inventing dubious reasons for monetary tightening. And mass unemployment goes on.
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> So how does this end? Here's a depressing thought: maybe it doesn't.
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> True, something could come along — a new technology that induces lots of investment, a war, or maybe just a sufficient accumulation of "use, decay, and obsolescence", as Keynes put it. But at this point I have real doubts about whether there will be events that force policy action...
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> I guess what I'm saying is that I worry that a more or less permanent depression could end up simply becoming accepted as the way things are, that we could suffer endless, gratuitous suffering, yet the political and policy elite would feel no need to change its ways. (Krugman, 2013)

This is possibly just a passing mood with him, the tearfulness of one who has spent a little too long crying in the wilderness – but then again, perhaps not. For something of a wailing chorus is beginning to make itself heard; other Jeremiahs have started to raise their voices, lamenting for the present and warning of fresh troubles to come.

Stephen D. King, Group Chief Economist and Global Head of Economics and Asset Allocation research at HSBC, and author of *When the Money Runs Out,* is one of those offering 'Cassandra-like predictions' (p. 5). Another is Michael Pettis, professor of finance and economics at Peking University. Despite their different vantage points, a sense of foreboding fills them both; as the titles of their most recent books suggest, they discern some kind of looming crisis on the horizon; the path ahead is 'perilous' for Pettis, while for King it could well lead to a state of 'dystopia' (chapter 9). But to what extent does their shared feeling of dread imply a common understanding about why fresh disaster this way comes so soon after its predecessor? And, as representatives of a profession seeking to redeem itself, what do they have to offer by way of suggestions about how we might avoid still yet another calamity?

Europe, the patient most clearly in need of economic surgery, has first call on those attending, though whether it is in truth a casualty of the Great Recession is a moot point, for its problems are often traced to the single currency it has chosen to adopt and which it could, in theory, discard. On this view the subprime debacle was the occasion, rather than the fundamental cause, of the continent's present ills, serving, as any crisis would have done, merely to reveal how the genes of the euro project preprogramed it for disaster. The diagnosis, then, is that the common currency is at heart a geopolitical project masquerading as an economic initiative: that the crisis currently afflicting the Eurozone is therefore *sui generis*; that its roots lie in the design of the single currency itself and so its onset in the era of the Great Recession is to a significant degree just a coincidence; and that the timing and character of its eventual denouement will owe relatively little to outside factors. Even allowing for its special nature, though, what do our economic specialists have to say about the travails and fate of the

Eurozone?

Stephen King and Michael Pettis find plenty of room for agreement here; they share the widely held view that the internal imbalances created by the drive for 'ever closer union' in the economic sphere are very destabilising, and that without radical steps the experiment is unlikely to end happily. As King notes, the political underpinnings needed to support the weight of a common currency have simply not been put in place, and in their continued absence the euro's prospects are dim.

> It would only work...if all countries within it recognized their mutual dependency and stuck by the house rules.
>
> The financial crisis showed that, despite their common membership of a single currency, countries would always default to national self-interest in hard times. Yet the pursuit of national self-interest — whether by government or by millions of creditors and debtors responsible for the flow of capital across borders — demonstrated that the single currency was a far from complete political project. Faced with a battle between the interests of northern European creditors and those of the southern European debtors in the wake of the financial crisis, the blame game took over.
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> In the absence of a well-defined fiscal union built on democratic principles, the risk of eventual Eurozone breakup is considerable.

The intensity with which the 'blame game' continues apace gives little cause for optimism, then. But King's account of it is built on the very important insights that as well as irresponsible borrowing, there is also such a thing as irresponsible lending, and that both have played their part in creating the current crisis in Europe (and indeed more widely in bringing about the Great Recession). This in no way serves to excuse those who acted profligately, of course; the citizens and their governments who borrowed and wasted on a heroic scale were not simply innocent victims of the suppliers of the financial rope with which they hanged themselves. But it is an argument, and a compelling one, that those who lend money have an obligation to consider factors other than yield, if only out of self-interest; *caveat creditor* indeed, just as much as *caveat debtor*. And if lenders fail to act in accordance with this obligation, as the northern European creditor nations undoubtedly did in the pre-Lehman era, then they have their own part to play in clearing up the resulting mess, and must offer sacrifices of their own. What form will these take?

For Michael Pettis, they will be linked, as for him everything is, to the flows of capital set in motion by asymmetries in the international exchange of goods and services. The lending and borrowing relationships between north and south in Europe were, on this view, not so much irresponsible as unavoidable, the inevitable consequences of a structural imbalance of trade, for the surplus capital created by the northern trade surplus had to find its home in investment in the south, thereby creating the conditions for the current impasse. The 'optimal solution' (p.

133) to the problem is therefore simple; the trade imbalances must be reversed, so that the Germans and their confreres deliberately engineer the importing of more goods from the south. The 'virtuous' north will suffer as a consequence, but for Pettis there will be no injustice in that, and it is in any case inescapable.

> The surplus countries are as responsible for the terrible European policies as are the deficit countries. They should share the burden of adjustment by reforming their own economic distortions. If Germany does not adjust dramatically, Spain [for example] will have no choice but to leave the euro and default on its debt.
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> The only question is when, and however the crisis is resolved, the adjustment will subsequently be very painful for Germany. That is why it makes sense for Germany to take measures that minimize the cost of the overall adjustment, even if this involves, as it will, slower growth and higher debt for Germany in the short term. (p. 134)

So much for what *should* happen. But those who demand, and pay, for answers want much more. They insist on knowing, unequivocally, what *will* happen, not just to the euro, but to the continent's economy. It is perhaps unfair to put such a question to economic forecasters, since, in Pettis' view, the outcome for the euro depends entirely on the politics of the issue, and European politics is a realm where, we might say, an unending desert of chaos is broken only by oases of uncertainty. It is in such a landscape, though, that a sudden and radical burst of enlightened self-interest must supervene. So, economists are being asked, what are the chances that the lightning of genuine concern for the common good will flash across the sky, illuminating the path to safety? Not high, in Pettis' judgment; '...Europe's crisis will probably lead to a partial breakup of the Euro as well as to defaults or debt restructurings among one or more European sovereign borrowers' (p. 1). But while the survival of the euro in its present form may be unlikely, it is at least still a possibility; the economic restructuring, on the other hand, must happen, Pettis argues, either by the reversal of trade flows or by default.

> *Without a strong form of fiscal union or a reversal of German trade surpluses, much of peripheral Europe will be forced to abandon the euro and to restructure its debt.* The problem facing Spain, Portugal, Italy, Greece, Ireland, and the rest of peripheral Europe is not lack of liquidity but rather a lack of competitivity caused by the huge divergence in costs over the past decade. One way of regaining competitivity is to force wages and prices down over many years of very high unemployment. Because, fortunately, this strategy is not compatible with democratic rule, these countries will eventually choose the only practical other way — to intervene in trade, which probably means to abandon the euro and devalue. Of course this will also mean debt restructuring and debt forgiveness given that their already excessive debt is denominated in what will be a rising currency...
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> The sooner the crisis is resolved the less damage there will be to local economies and the more quickly growth will return. (pp. 188-9)

There are three presuppositions in all of this that need bringing to the surface and examining, for they also inform Pettis' analysis of the Great Recession confronting the world outside Europe. The first is that the proper nature of our current predicament is not widely understood. Pettis believes unequivocally that it was caused by 'policy distortions, or distortions in the institutional framework' that created international trade imbalances and prevented them from correcting themselves naturally, resulting in an 'adjustment' that was violent in nature and took the form of a 'financial crisis', just as had happened many times before in history; 'In that sense, there is nothing unique, unexpected, or even surprising about the recent global crisis' (pp. 10–11). Pettis takes it for granted, secondly, that the key to any solution lies in the hands of policy makers, for 'The crisis will not be truly over until the policies and institutional framework that led to large trade imbalances have been sufficiently modified' (p. 11). His third postulate is that some kind of reversion to the ***status quo ante,*** to the world before Lehman, is possible; 'growth will return' (though, as we shall find, not at a rate anything like as high as that of the recent past).

Taken together, these axioms undergird a view of the contemporary scene seemingly rather different to that offered by Stephen King. His preoccupation is much less with trade patterns than with what he sees as the remarkable weakness of the current economic recovery, particularly in the West, a development he takes as a sign that the crisis brought on by the Lehman shock differs in kind from those to which affluent nations had become accustomed since 1945; 'In the past, deep recessions were always followed by strong recoveries. Not this time,' he warns (p. 32), since, on this occasion, we must acknowledge that we face '... a financial crisis without parallel. Never before have we seen so many economies so weak at the same time and never before have we seen a global financial system so badly damaged' (p. 4). Like Pettis, King believes that most observers do not discern a fundamental truth about today's economic reality, but for him this is less a matter of intellectual shortcomings than of an unwillingness to give up unrealistic hopes about present and future prosperity. So the fair maiden of economic distress has no hope of rescue at the hands of the chivalric order of central bankers; for King is convinced that in circumstances like those confronting us today, the scope available to policy makers for effective action is really very limited. Indeed, a good part of his book is taken up by describing how, since Lehman, they have tried and are largely failing to deliver that prosperity, and, worse, how their efforts are now, in fact, doing more harm than good. This leads to the bleak conclusion that societies, in the West especially, need to shed — and quickly — some of their most cherished illusions and prepare instead to embrace the harsh reality that is bearing down on them remorselessly.

> We thought we could govern our futures. We became delusional. We convinced ourselves that capital markets could deliver ever rising prosperity. We thought we could borrow without limit, always confident that the future would be better than today. Not for one moment did we think that we would ever succumb to Japanese-style economic stagnation or Argentine-style broken promises. Instead, we basked in an 'optimism bias'.

> Our beliefs, it turns out, were false. Rapid economic growth is not guaranteed. Indeed, the more we believed it was guaranteed, the less stable our economic foundations became. Those foundations are now crumbling, not so much through a failure of macroeconomic endeavour but, instead, through a grass-roots breakdown in trust.
>
> Through our pensions, our health care, our high levels of debt, our (fast-waning) belief in financial alchemy and our refusal to accept that this is anything but a cyclical economic setback, we are persistently trying to consume tomorrow's income today... It is time to drop the pretence that we're simply living through a cyclical blip. Instead, we urgently need to tackle the structural problems that threaten all our economic futures. (pp. 260-261)

As King notes, this line of argument runs counter to the widely held view that 'Normally, things shouldn't go wrong. On the rare occasions that they do, our policy-makers will put things right. There may be bumps along the way but the path towards ever rising prosperity is nevertheless secure' (p. 60). These articles of faith are of great comfort to the many in the West who still believe in them and who, in reciting this creed, affirm that all economic recessions are one, and that all things shall be well and all manner of things shall be well if only the right tools are used in the right ways at the highest levels. King is a heretic on both counts. He does not deny that macroeconomic policy since Lehman has had some measure of success, since 'there has been no repeat — at least, not yet — of the total economic and financial collapse of the 1930s (p. 3). But this is not setting the bar particularly high, and certainly not as high as Western societies have come to expect since 1945. Yet, King argues, it is all that is now possible; macroeconomic policy has already reached the outer limits of its effectiveness, and those who continue to place their faith in it are misguided. Such assertions are certainly topical; the Federal Reserve may currently be preparing the ground for a tapering of its quantitative easing program, but that program is still in place, while in Japan 'Abenomics' threatens to unleash a turbocharged version of the 'Bernanke put' on the unsuspecting public. So it is important to examine closely the reasons why King thinks such initiatives are at best likely to prove disappointing in the extreme, and will at worst constitute an exercise in self-mutilation.

His basic contention is that events have proved that the macroeconomic medical emergency bag, when opened for use once again in the aftermath of the Lehman shock, proved to contain not a set of precision surgical instruments designed to restore the Western patient to economic health, but rather an ill-assorted collection of jemmies and crowbars suitable mainly for burgling his house while he lay prostrate. These implements are, in the order in which they have been used: interest rate cuts, quantitative easing, and 'financial repression' (which in this instance partly takes the form of enhanced liquidity buffers for banks that have the effect of making it easier for governments to borrow and spend). For King, each successive step betrays an increasing desperation and a growing powerlessness on the part of central authorities.

A rapid and sustained reduction in interest rates is normally the first weapon of choice in combating an economic downturn since, in theory, it should encourage businesses, house-buyers and consumers to borrow and spend, stimulating both supply and demand. That, King argues, has simply failed to happen.

> In March 2009, UK bank rate — the interest rate set by the Bank of England — fell to a mere 0.5 per cent, the lowest since records for this particular series began in the 1970s. Three years later, bank rate remained at this — by historic standards — absurdly low level. By that stage the UK government's long-term borrowing costs had dropped to well below 2 per cent, the lowest since records began in the early 1970s.
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> The UK's experience was hardly unique. At the end of 2008, shortly after the collapse of Lehman Brothers, US Fed funds — the equivalent of UK bank rate — dropped more or less to zero. And, as with the UK, US government borrowing costs plummeted. The same was happening in parts of continental Europe, notably Germany.
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> Initially, central bankers hoped remarkably low borrowing costs would kick-start economic growth. It didn't work. Success would have allowed interest rates to have gone straight back up again. Their failure to do so tells us a great deal about the implications of the financial crisis. An interest rate is, after all, a payment for consumption foregone. Those who wish to invest for all our futures are prepared to pay a higher interest rate on any borrowings - to encourage us to defer consumption — if the future is seen to be particularly bright. If, on the other hand, the future is regarded as decidedly murky, interest rates are likely to remain persistently low, reflecting an absence of capital investment. (p. 71)

So, according to King, gunning the economic engine by pushing interest rates flat to the floor proved a failure — it evoked no response, no lusty, growling roar of animal spirits from the recipients of central banks' largesse. They just sat tight, refusing to respond as the owner's manual had predicted. True, the silence was not unbroken, but the sounds that assailed the ears of the authorities turned out on closer inspection to be the howls of savers deprived of their accustomed rewards. Yet the central banks now found themselves in a quandary, for there could be no question of raising rates in response to the outcry; the recovery was anaemic enough already, and a rate rise would only depress economic activity. So the decision was taken to double up on the grand monetary bet, to become daringly 'unconventional' and boldly go where no U.S. Federal Reserve had gone before, into the brave new world of quantitative easing.

King is equally unimpressed by the results of this initiative, which involved central banks buying up private debt, including some toxic assets, in the U.S., and government bonds in the U.K. The theory was that this would depress yields and force investors to look for more productive, if riskier, havens for their capital, kick-starting the economic cycle in the process. But the results to date, he says, are distinctly underwhelming.

> ...the economic outcomes have been worse than the proponents of quantitative easing themselves foresaw.

> In mid-2012, for example, the Federal reserve's top policy-makers thought US economic growth would be in a range of between 2.9 per cent and 3.8 per cent in 2010 and between 2.9 per cent and 4.5 per cent in 2011. The actual outcomes were 3.0 per cent and 1.7 per cent respectively. In other words, the US economy's performance was significantly worse than even the most cautious of the forecasts offered by the Federal Reserve in the middle of the previous year. The Bank of England was similarly optimistic, believing that the most likely outcome for economic growth in the UK in 2011 was around 3 per cent, a view conditioned by on £200 billion of asset purchases (in other words, quantitative easing). The actual outcome was a more modest 0.7 per cent...
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> The evidence strongly suggests that quantitative easing, in its various forms, is not the magic wand it was often made out to be. (p. 74)

QE failed to change the public mood, King believes, because it was too arcane to be widely understood. And once again, he asserts, relative failure was far from cost-free; QE increased the stress on pension funds, already in trouble as a result of low interest rates, and its chief beneficiaries, particularly the already wealthy, either did not use their windfalls in ways that contributed to growth or chose to invest them overseas rather than at home. Worst of all, QE had the effect of making the lives of governments easier by blurring the distinction between fiscal and monetary policy, in the process eroding the independence of central banks. Having these entities buy up government debt is 'a form of financial repression, a way of ensuring that the government is able to rig credit markets to suit its own aims even if the economy as a whole may perform less well as a consequence' (p. 80).

The ratchet of 'financial repression' was tightened another notch, King goes on to argue, by the reform program imposed on banks in the aftermath of the subprime collapse. By requiring them to hold greater amounts of the 'safest' assets, defined by the Basel Committee as sovereign paper, 'Regulation... forces banks to lend more to governments than to other potential borrowers, *whether or not the governments are, themselves, a good credit risk* (p. 84). This reinforced the effect of QE, which had already started to allow 'governments to raise credit on the cheap...[and] merely...to postpone the fiscal 'day of reckoning' (pp. 80-81).

On this reading of events, then, it would seem that the West is in the process of destroying piecemeal the distinctive market system, and along with it the democratic accountability, on which it prides itself. For financial repression is, as Michael Pettis notes, one of tools favoured by followers of the Asian development model, and especially by the Chinese Communist Party. As he describes them, the consequences of taking this road are clear.

> The banks...are controlled by the monetary authorities that determine the direction of credit, socialize the risks, and set interest rates. Financial repression is a way of describing a system in which the rates of return and the direction of investment are not determined by market conditions and individual preferences but rather are heavily controlled and directed by financial or political authorities. At the extreme the financial system is often little more than the fiscal agent of the government...

> In most countries that create the conditions of financial repression — for example the countries that broadly followed the Asian or Japanese development model — interest rates have been set extremely low...
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> Depositors... have no choice but to accept very low deposit rates on their savings, which are then transferred through the banking system to borrowers, who benefit from these very low rates...
>
> Those who lose under conditions of financial repression are net depositors, who tend for the most part to be the household sector. The ones who win are net borrowers, and in most countries in which financial repression is a significant policy tool, these tend to be local and central governments, infrastructure investors, corporations and manufacturers, and real estate developers. Financial repression transfers wealth from the former to the latter. (p. 60)

It seems likely that Stephen King would agree that this is a pretty accurate description of what is currently happening in the West as a result of QE and the other responses by the authorities to the Great Recession. And it is, for him, a very worrying development.

> Central bankers are not elected politicians. They are mostly selected for their economic and financial skills, not because they know how to please an electorate. Yet they are increasingly making decisions that are inherently political. By allowing inflation to be temporarily higher than target, or by choosing to buy government bonds or other pieces of financial paper, they are making some of us better off and others worse off. In a stagnant economy, quantitative easing and other such exotic policies have only ended up robbing Peter to pay Paul. It is as if a morally indifferent Robin Hood had suddenly arrived on the scene, chaotically redistributing income and wealth using neither rhyme nor reason.
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> Not surprisingly, these kinds of tricky political decisions, combined with ongoing economic stagnation, have undermined public confidence in central banks. (pp. 91–92)

But perhaps the erosion of democratic accountability will prove to be a small price to pay if it can deliver the return of growth? For, according to Michael Pettis, this seems to be what financial repression produces, since the very low interest rates that usually accompany it effectively entail a transfer of resources from (mainly household) savers to borrowers (governments and companies), the sector of the economy 'that generates production and economic activity.' Hence, 'Very low lending and deposit rates create a powerful mechanism for using household savings to boost growth by heavily subsidizing the cost of capital' (p. 61). Was this not, after all, a hallmark of Japan's path to greatness after 1945? And has not China been following in its wake?

Yet before accepting this contention, we should note that there are troubling aspects to Michael Pettis' view of the way the world works. The phenomena he describes seem rather too mechanical in nature, with successful management of them seemingly guaranteed automatically by the correct policy mix. His book rests rather too comfortably on the assumption that predictable consequences will flow from specific actions. He is drawn to this view of economic reality by the belief that he is dealing with a closed, rather than an open, system, and that the mere existence of boundaries reduces the problem to manageable proportions. Much of this confidence stems from his conviction that he has discovered an 'iron law' that is a simple and infallible guide to the understanding of trade imbalances and their effect on the world (a vital matter in his view since, as we have already seen, he believes that our sufferings today are largely a consequence of such imbalances). This iron law he explains as follows.

> If a country saves more than it invests domestically, these excess savings must be invested abroad, and one of the automatic consequences of net foreign investment is an excess of exports over imports. Every country that has net investment abroad ...must generate more revenues from the export of good and services and from foreign interest and royalty payments than it pays out.
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> This simple fact, known as an accounting identity, goes a long way toward illuminating trade imbalances. In fact just three accounting identities — which are true by definition and so can never be violated — are enough to make sense of what otherwise seems like an incredibly complicated phenomena [sic]. These are the following:
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> 1. For every country...every dollar that enters a country, either in payment for that country's exports, in the form of royalty or services receipt, or in the form of foreign investment in domestic assets, must leave that country, either in payment for imports, in the form of royalty or services expenditure, or in the form of outward investment...
> 2. For every country, the difference between total domestic savings and total domestic investment is equal to the net amount of capital imported or exported...This means the excess savings must be exported. By exporting capital abroad, that country must "import" it back in the form of a current account surplus...
> 3. Everything that a country produces must be either consumed or saved (and "consumption" includes even assets or resources that are thrown away or otherwise wasted). (pp. 17–18)

Pettis does not claim to be the discoverer of these truths, but he does affirm that he is employing them and other insights in an entirely new way; his purpose and achievement are, he says, to 'extend our basic knowledge of open economies and apply it to the global economy as a single closed system in order to show the many surprising ways policies and conditions are related' (p. 12). His use of his 'accounting identities', therefore, seems Newtonian in scope, the economic equivalent of seizing on the implications of the third law of motion which decrees that 'every action has an equal and opposite reaction.' Hence, for example, his argument that 'Any distortion in one country's position that affects its international trade and capital position must be reflected in an equal and opposite distortion elsewhere' (p. 106). But does any of this in truth go much beyond the level of tautology, does it do much more than state that one country's export is another country's import, and that payment for an import must be exported? Certainly by invoking his deterministic 'accounting identities' Pettis does seem to be suggesting that certain things 'must' happen, and are therefore in some form capable of supporting predictions. But even if we accept, as we must, that the global economy is a 'single closed system', that does not in reality make the task of accurate forecasting one jot less difficult. In fact, on the evidence that Pettis presents, it in fact becomes much harder, approaching very swiftly indeed the borders of the impossible. For, throughout his book, he is at pains to show how

> ...there is a wide variety of policies and institutional structures that can have significant impacts on the trade balance, even when they may at first seem unrelated to trade. Anything that affects the gap between savings and investment, it turns out, must automatically affect the trade balance.
>
> Of course this also means that because anything that affects the gap between production and consumption also affects the savings rate, it must also affect the gap between savings and investment. This is the key point. A very large number of policies or conditions are likely to affect production or consumption or the relationship between the two, in which case these policies or conditions are directly or indirectly also likely to affect the balance of trade. For this reason they are functionally equivalent to trade policies even if they are not intended as such. (p. 47)

So, in theory, we now understand and can now trace the impact of a much wider range of influences that had previously been discounted and thereby arrive at a proper understanding of how trade imbalances are created, the vital first step to correcting them. But how much practical help do such insights afford us?

It is certainly the case that we owe Michael Pettis a genuine debt for drawing attention to the complexity that conditions trade imbalances. It is also good to be reminded once again and in a new form of words that countries in the world today are indeed very interconnected and interdependent, and that not one of them is in complete control of its own destiny. And this highlights one of the reservations we must have about Stephen King's study; for, penetrating as some of its part are, its general focus is too narrow, it concerns itself too much with the West, and it is an obvious fact that the economic fate of the West is no longer entirely in its own hands. But merely thinking on a global scale, as Michael Pettis does, is not sufficient either. For while we cannot now avoid conceiving of a 'single closed system' that encompasses the entire globe, this merely complicates our task beyond all hope of comprehension, since while that system may indeed be closed, it is also, resolutely, a deterministic nonlinear one. Here we trespass onto the terrain of chaos theory, to borrow its vision of multiple independent variables interacting in patterns vastly too complex to be captured by simple 'accounting identities,' or to be predictable beyond anything other than the very short-term. It may be going too far to say that as economic beings we belong to a world of 'sensitive dependence upon initial conditions', otherwise known as the 'butterfly effect', whereby a single event can cascade, or not, across scales. But we cannot avoid noting that the butterfly in question and the storm it is supposed to create have changed locations more than once in the telling of the story, and that this is not without meaning, for in truth both economic insect and tempest can appear at many, if not all, spots on the face of the earth today. So while a policy initiative in one country may have a clear set of desired goals, its chances of achieving them and the actual effects it ultimately produces will be conditioned by the responses of all of its trading partners. We might even envisage a situation in which a policy, perfect in its rationale and expectations, has the opposite effect of the one intended because of the manner in which it collides and interacts with multiple other policy initiatives elsewhere in the global system.

In seeking to offer advice to policy makers, then, throughout his book Michael Pettis fights an unavailing battle against the inherently unpredictable nature of a truly global economy. All the many hypothetical examples he gives to illustrate his contentions are so hedged about with qualifications that they have very little to offer those who go in search of accurate forecasts of reality, and who desire to know in advance the actual results of policy initiatives. Take, for example, his discussion of how the U.S. might act to reduce its trade deficit with China (pp. 109-113). It is true that initially he offers this as a case study to prove that the conventional wisdom about how this could be done is wrong, because said wisdom treats the U.S. / China trade relationship as a closed bilateral system when in reality it is far from that. Even restricting himself to a hypothetical world of just four countries, the U.S., China, Brazil and Mexico, Pettis is able to show how a U.S. attempt to reduce imports from China by devaluing the dollar against the renmibi could only work absent any compensatory or retaliatory action in the other three countries, an extremely unlikely scenario. But at this point he move on from analysis to prediction and the offering of advice, concluding from the example he has given that it is U.S. domestic rather than international policy that needs to change.

> If the United States really wants to see its trade deficit decline, it should move aggressively to alter the balance between domestic production and consumption in a more permanent way, perhaps by raising consumption taxes, although this will work mainly by increasing U. S. and Chinese unemployment if China increases its intervention in the currency or in interest rates and credit. In that case we would be in a beggar-thy-neighbor world, and in that world global unemployment always rises. (pp. 112-113)

This is a black picture indeed, and also one that seems completely at odds with the prediction that he offers on the same subject in the concluding chapter to his book. There, looking to the future, Pettis affirms that

> ...as trade anger rises in the United States and more steps are taken to intervene in trade, the closing of the U.S. trade deficit will automatically cause a boost in domestic growth and in the domestic savings rate.
>
> In fact should the United States take drastic steps to reduce disposable income relative to GDP, like imposing a consumption tax or much higher income taxes on the wealthy, the positive impact on U.S. unemployment and the U.S. savings rate will be dramatic, although it will be extremely difficult for countries, like China and Japan, that rely on American overconsumption to balance their own underconsumption. (p. 186)

So in scenario 1 (p. 112) reducing the U.S. trade deficit with China by raising consumption taxes in the U.S. would increase unemployment there, while in scenario 2 (p. 186) it would have a 'positive impact' on U.S. unemployment. How to explain the apparent contradiction? It is easily enough done, since in scenario 1 an increase in U.S. unemployment is caused by the Chinese response to U.S. policy, while in scenario 2 this response is absent. The full measure of the unpredictability inherent in a global economy thereby stands revealed. Once again, when we try to move from the world of 'should' to the world of 'will be', we find ourselves stymied immediately.

Yet Professor Pettis is not discouraged. He ends his book with nine predictions: that the U.S. will be the first to recover from the current crisis; that Germany will suffer from sharply slower growth and banking losses for many years; that, absent fiscal union or unilateral German action, the weaker members of the Eurozone will leave the common currency; that China will experience a long and bumpy landing; that Japan will not be able to export its way out of its current problems; that countries that rely on non-food commodities will not benefit from a Chinese rebalancing; that growth in global demand will remain weak for many years; that trade tensions will rise; but that in the end a global rebalancing must and will occur (pp. 185-194). These may, in truth, be no more than educated guesses, and there are, quite understandably, no dates attached to them. But it is interesting to note the marked degree of pessimism about growth rates that Pettis and Stephen King have in common and which derives, ultimately, from the conviction that past sins have to be paid for, that their consequences cannot be evaded by quick fixes, monetary, fiscal or otherwise. In the case of Michael Pettis, it is the distortions in global trade balances that are unsustainable; stretching these to the limits of their elasticity, as has been done in recent years, means that whenever they snap back, as they must, the shock will be harder and more painful. For Stephen King, as we have seen, the current malaise was created by the illusions of the pre-Lehman era, and a meaningful recovery cannot begin until these illusions are despatched to the wilderness once and for all, and we begin the grim task of lowering our expectations and paying our bills as they come due.

So another Lehman-like moment looms ahead, it seems. To what extent and in what manner can the unavoidable crisis be confronted and contained? How are we to try to mitigate its effects in advance, so that we will be able to respond without the panic of 2007-2008? Here, as we have seen, Michael Pettis, in confining himself to the world of policy-makers, has rather less to offer than Stephen King; for given the global nature of the modern economy, no one set of policy-makers now exerts anything like full control over its nation's destiny, and hopes of selfless international cooperation between policy-makers, as rationally desirable as this may be, are so politically naïve that very little time need be wasted on them (and here Europe serves as microcosm). Which leaves us, at national level, as Stephen King argues, with ourselves alone, and with our own attitudes and expectations. Some of these must change, and better that concessions to the inevitable are offered quickly and voluntarily rather than being extorted from us by events slowly and a great deal more painfully. We must, in the first place, give up all hope of being rescued from the consequences of past actions by some central bank, or central government, alchemy; we should learn, secondly, that lending as well as borrowing is subject to the constraints of responsibility; and, thirdly, we should understand that waste in any form, whether the abandoned housing projects that still disfigure the countryside of Ireland and Spain (and may soon disfigure that of China) or the 'welfare' system enjoyed by Greece until recently, poses the greatest threat to the interests not just of the current generation, but of those to come who will still be paying for it when its authors are no more.

Such, perhaps are the outer limits of what is possible today in terms of guidance about the future. More than that cannot be asked even of economists as gifted as Stephen King and Michael Pettis; in terms of detailed forecasts about what is to come, better indeed a confession of ignorance than the commission of error by claiming to know anything of what is forever hidden from our sight. And if their books are symptomatic of a change of mood and of a new self-awareness amongst economists, then it would seem that Lehman has left a somewhat chastened and much charier profession bobbing around in its wake — which may be of help in times to come.

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