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Debate

From Marx to Morgan Stanley: Inequality and Financial Crisis

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ABSTRACT

Despite robust growth, rising inequality is widespread in many countries. At the same time, financial instability and crises are occurring with greater frequency and severity. These two phenomena are related to the contest between labour and capital for a greater share of economic output, with capital gaining a greater share over the past few decades. As a result, there is a tendency towards a decline in consumption by the average household and a rise in savings by a rich minority which could cause stagnation in the economy. This tension between declining consumption and rising savings is 'resolved' by the financial system through the recycling of funds from the rich minority to the average household in the form of credit. Financial engineering in the USA exacerbated this process which led to excessive lending and borrowing, and the creation of an unsustainable debt and asset bubble that eventually imploded. There is a similar tendency towards greater inequality, a falling share of consumption and a rising share of savings and investment in China. In the context of a globalized economy, the tension is 'resolved' through recycling 'excess savings' from China to the US, adding to the debt and asset bubble in the US.

INTRODUCTION

Globalization in its most basic sense refers to the increasing integration of the world's economies through trade, capital, labour and information flows. Globalization has brought with it increases in productivity and wealth generation. World trade has risen faster than world GDP. But globalization has also been accompanied by rising inequality not only between countries but even more so within many countries (Milanovic, 2002; Wade, 2004). At the same time, with the liberalization of the financial sector, beginning in the United States and later exported to many other countries, and with the liberalization of capital flows between countries, we have witnessed an increase in the frequency and severity of financial crises. A World Bank study noted that there were 137 banking crises between 1970 and 2007, averaging 3.7 per year (Caprio et al., 2003). A major banking crisis breaks out every ten years with almost clockwork precision. In the late 1980s, it was the savings

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and loans crisis in the USA; in the 1990s, it was the Japanese banking crisis and the Asian Financial Crisis; and in the late 2000s, it was the recent global financial crisis and recession.[1] Minsky (1986) presciently argued that as the financial sector moves increasingly from hedge financing to speculative and Ponzi financing, financial fragility becomes more pronounced and financial crises become more frequent.

Among the macro-economic imbalances that have been put forward to explain the Great Financial Crisis (GFC), the trade imbalance between current account surplus countries like China and other Asian countries, and current account deficit countries, most notably the USA, has been cited as the most important cause. Two other structural imbalances that are equally important are less discussed; these are the imbalance between the financial sector and the real economy, and the imbalance in income and wealth between the rich and poor.[2]

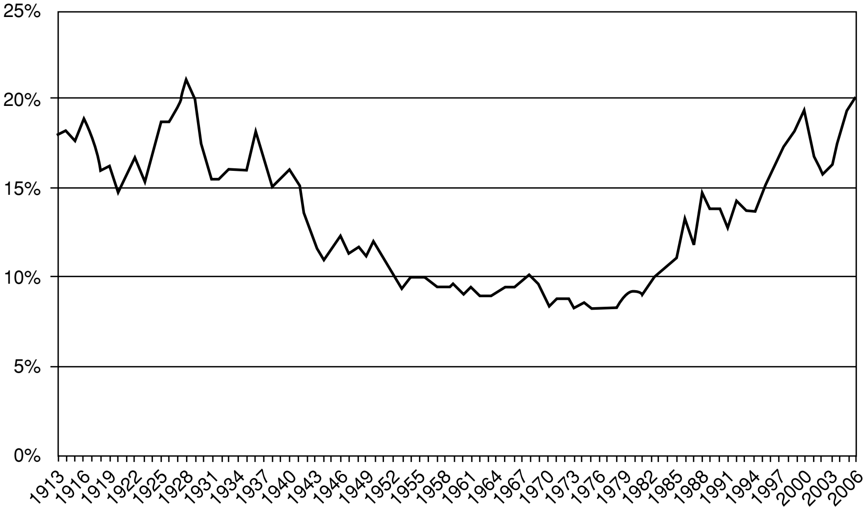
INEQUALITY, THE GREAT DEPRESSION AND THE GREAT FINANCIAL CRISIS

It is instructive to note that the Great Depression of the 1930s was preceded by rising and extreme inequality (see Figure 1). Among the structural weaknesses preceding the Great Depression identified by Galbraith (1997: 177) was high income inequality — in 1929, the top 5 per cent of the population received one third of all personal income. In recent years, the US has reached a level of inequality higher than that of the pre-Great Depression period. The Gini coefficient of the US was 0.47 in 2006 compared with an estimated 0.45 in 1929 (Wikipedia, n.d.). But this phenomenon has been largely forgotten in most discussions of the GFC, with a few exceptions including Klein (2010), Krugman (2010), Lim (2009), Lim and Lim (2010), Milanovic (2009) and Rajan (2010).

A key to understanding the long-term structural causes of the GFC is the link between growth, inequality, financial innovation and debt. Important structural changes occurred in the US economy after World War II. After an initial period of robust growth (1940s to 1960s) that saw a rise in real wages and decline in inequality, economic growth began to decelerate and the economy became increasingly driven by debt and asset inflation rather than growing incomes. Between 1960 and 2007, as the US GDP rose by 27 times from US$ 526 billion to US$ 13.9 trillion, the total debt of the economy leapt by 64 times from US$ 781 billion to US$ 49.9 trillion (see Table 1). Even more significant is the composition of the total debt: financial debt increased 490 times, household debt 64 times, non-financial corporate debt 53 times and government debt 24 times.

1. We shall refer to this recent financial crisis as the Great Financial Crisis (GFC).
2. These three imbalances are discussed in Lim and Lim (2010).

Figure 1. Income Share of Highest Income Households at Highest Level since 1928 (Share of Total Pre-Tax Income Flowing to Top 1 per cent)



Source: Krugman (2010).

Income and Wealth Inequality

During the period 1970 to 2006, real wages of ordinary workers stagnated and inequality worsened by any number of measures. The Gini coefficient for income deteriorated, rising from 0.35 to 0.46, placing the US closer to developing countries like Malaysia and Guatemala (0.48) and Argentina (0.52), than to developed countries like Canada (0.33) and Japan (0.25). This meant that the top 2.7 per cent of households earned 20 per cent of total income while the bottom 6 per cent earned only 0.3 per cent. Growth in real income was heavily concentrated in the top 1 per cent. Saez (2008) showed that between 1993 and 2006, the top 1 per cent of income earners captured half of the overall economic growth, with the problem worsening under the Bush administration's liberal tax relief for the rich through which they captured three quarters of income growth. Distribution of wealth is even more skewed with a Gini coefficient of 0.8: the top 20 per cent owned 85 per cent and the top 1 per cent owned 33 per cent of total wealth in 2001, whereas the bottom 80 per cent owned only 15 per cent of total wealth (Domhoff, 2005: 2).

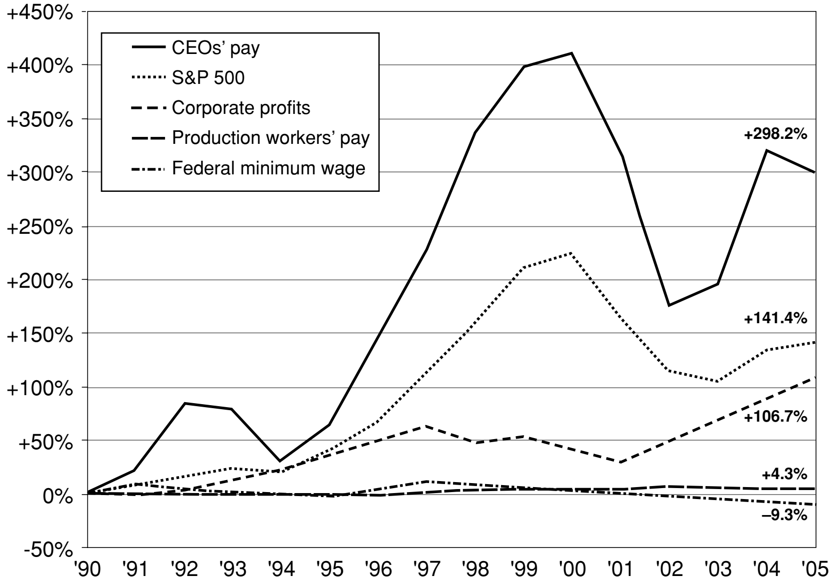
Figure 2 shows this unequal distribution in another form. Between 1990 and 2005, the federal minimum real wage fell 9 per cent and production workers' pay rose 4 per cent, while CEOs' average compensation increased by 298 per cent, outstripping the rise in corporate profits of 107 per cent.

Table 1. US GDP and Domestic Debt by Sector, 1960–2007.

			Domestic Debt by Sector					
	GDP US$ billions	Total Debt US$ billions	Financial Sector US$ billions	Non-Financial Corp Sector US$ billions	Household Sector US$ billions	Government: Local, State, Fed US$ billions	Rest of World US$ billions	Dom Fin + Non-Fin Corp Debt US$ billions
1960	526	781	33	201	216	308	23	234
1965	719	1,107	62	305	339	365	38	367
1970	1,038	1,600	128	514	457	450	52	642
1975	1,638	2,619	260	864	734	663	97	1,124
1980	2,789	4,725	578	1,478	1,396	1,079	193	2,056
1985	4,220	8,623	1,257	2,578	2,278	2,268	243	3,835
1990	5,803	13,769	2,614	3,753	3,598	3,486	318	6,367
1995	7,398	18,475	4,234	4,134	4,857	4,684	567	8,368
2000	9,817	27,143	8,145	6,589	7,011	4,583	815	14,734
2005	12,434	41,244	12,969	8,472	11,740	6,556	1,512	21,441
2007	13,971	49,882	16,155	10,588	13,815	7,313	2,016	26,743
Growth x Time 1960–2007	27	64	490	53	64	24	88	114

Sources: Economic Report of President (2008: Table B-1); Federal Reserve System, Board of Governors, Table L.1 Credit Market Debt Outstanding (http://www.federalreserve.gov/releases/z1/current/z1r-4.pdf)

Figure 2. Cumulative Per Cent Change in Economic Indicators, from 1990 (in 2005 dollars)

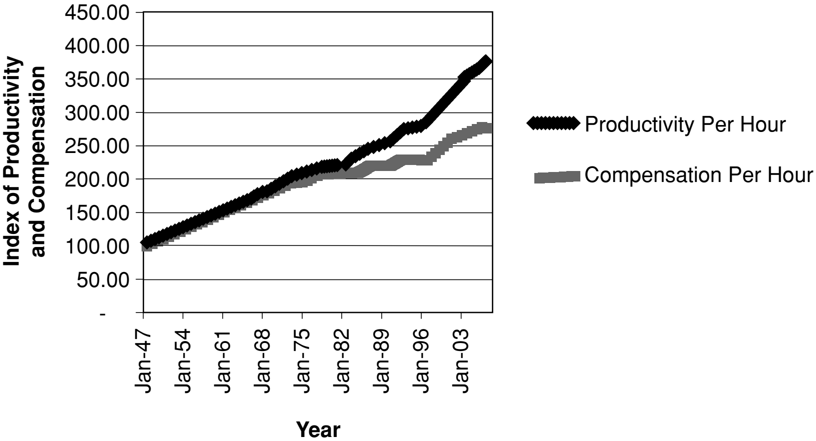


Source: Domhoff (2005).

We are taught in economics that wages of workers are determined by their marginal productivity. However, recent trends belie this tenet (see Figure 3).

From the mid-1940s to the mid-1970s, there was a tight fit between productivity gains and real wages in the US. But this began to diverge significantly after President Reagan dismantled the National Relations Board, broke up the air traffic control labour union, and renegotiated the accord between labour and capital in favour of the latter (Bowles et al., 1986). Capital's share of income rose with successive tax cuts in dividends, capital gains, corporate earnings and estate duties. In other words, the share of GDP going to labour versus capital is less a result of marginal productivity and more dependent on labour's bargaining power, which has weakened with the ascent of neoliberal policies. Roach (2009: 100, 143, 242) showed that this was happening not only in the US, where real wages increased by 1.6 per cent while productivity rose by 3.3 per cent in the period 2001–2006, but also in Japan, Canada and twelve European countries, where the share of GDP to labour fell from 56 per cent to 53.7 per cent between 2001 and 2006 whereas the share accruing to capital was at a record high. Roach argues that globalization did not confer equitable benefits to everyone; one of the great asymmetries in globalization is that in the contest between labour and capital for returns, the pendulum of economic returns has swung from labour to

Figure 3. Non-Farm Productivity versus Compensation in the US 1947–2008



Source: Bureau of Economic Analysis (n.d.)

capital in the developed world. He also argues that this trend is unsustainable and has to reverse at some point in the future.[3]

Greenspan alludes to the same problem in his recent memoir. He says he is puzzled by this divergence between productivity and real wage increase and is worried that if real wages do not rise more quickly for the average US worker, political support for free markets may be undermined (cited in Guha, 2007).

MARX, MORGAN STANLEY AND THE GLOBAL LABOUR ARBITRAGE

Labour's bargaining power has been weakened by another important global trend, what Roach (2009: 98–102; 184–87) calls 'the great labour arbitrage'. With China, India and many other emerging markets becoming more integrated into the world economy, globalization has sucked vast pools of rural and unemployed workers into the labour market, putting downward pressure on wages in developed countries. It is estimated that China, India and the former Soviet Union added about 1.5 billion new workers to the global economy (ibid.: 144). Entry wages of average Chinese manufacturing workers

3. Roach (2009: 98) also asserts that in the developing world, the benefits of growth have accrued mainly to labour. However, his own data on China weaken his argument. He says 'productivity growth in China's industrial sector... surged at an average annual rate of nearly 20 percent over the 2000–2004 interval. That's well in excess of cost pressures implied by 12 percent gains in hourly compensation' (ibid.: 186). A World Bank study showed that between 1998 and 2005, the share of China's GDP going to labour dropped from 53 per cent to 41 per cent (see *The Economist* 11 October 2007).

have remained relatively flat during the last three decades of rapid growth because of the large pool of migrant workers from the countryside to the cities. While wages have grown quite rapidly for skilled and experienced workers, average wages have still lagged behind the growth in labour productivity and are still low by international standards. Indeed, the average wage of the Chinese manufacturing worker was estimated at 57 cents per hour in 2002, which was only about 3 per cent of the average US hourly pay (ibid.: 184). However, the supply of migrant workers has been dwindling in recent years, due in part to the impact of China's one-child policy on population growth. As a result, there has been an increasing upward pressure on wages in the coastal cities, leading factories to move inland and to source workers from poorer neighbouring countries like Vietnam. In recent months, pressure and demand for higher wages have led to strikes and lockouts in various foreign-owned factories in the coastal cities (Pilling, 2010; Ramzy, 2010; Tabuchi, 2010). This may signal the start of a secular trend towards higher real wages in China in line with productivity growth and a rising share of labour in economic output.

What Roach calls the great labour arbitrage recalls what Marx wrote about over 200 years ago when he analysed the dynamics of capitalism.[4] In its constant search for markets and profit, capitalism has to ceaselessly expand; it cannot stand still. The basic contradiction in capitalism is between capital and labour and their struggle for a bigger share of the economic pie. While this struggle may have been muted and transformed over time, it has not been eliminated and continues to drive the system. In its quest to enhance profit and to accumulate, capital must constantly look for ways to reduce the cost of labour, increase productivity and appropriate most of the surplus. One way to achieve this is to use more machines and less labour — this not only raises the productivity of labour but also reduces the bargaining power of labour to the extent that the excess workforce are not re-employed in other industries, thus increasing the size of the labour pool.

Strategies to Enhance Profits

Other recent strategies of capital to augment profit and reduce labour costs include the use of temporary, part-time and contractual workers who are paid lower wages, have few, if any, benefits and weak bargaining power. Over the last decade, we have witnessed the phenomenon of 'jobless recovery' (Akyuz, 2006). Charles McMillion, the president and chief economist of

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4. It is interesting to note that some Wall Street financiers pay more attention to Marx's contribution to the analysis of capitalism than most economists. A wealthy investment banker was quoted in the *New Yorker* magazine saying, 'The longer I spend on Wall Street the more convinced I am that Marx was right. . . I am absolutely convinced that Marx's approach is the best way to look at capitalism' (Wheen, 1999: 5).

MBG Information Services in Washington, an expert on employment issues, said that there are now 3.4 million fewer private sector jobs in the US than there were a decade ago. In the last ten years, we've seen the worst job creation record since 1928–1938 (Herbert, 2010.) Even as the economy expanded, full-time jobs did not grow as fast. Most of the new jobs created were temporary, part-time or contractual by nature and in the low-wage sectors. These changes occurred not only in the US but also in Japan, a country known for job security. In Japan, between 1991 and 1998, while the ratio of regular to total workforce for all workers rose slightly, this ratio fell for workers under thirty years of age, creating a chasm between older workers with security and younger workers without security (Yuji, 2006: 33). This pattern is repeated in many European countries under the banner of increasing labour flexibility. In Spain, about a third of the workforce has little job security and few benefits, pitted against the older workforce with permanent status (Schuman, 2010: 21).

Another financial strategy to enhance profits is the widespread use of leveraged buy-out where investors or management borrow heavily to buy out well-run companies, ramp up their leverage, and ruthlessly trim the workforce to maximize profits and shareholder value (see Lim and Lim, 2010: 31–6). With the political onslaught waged by capital, supported by liberal state policies that reduce taxes in favour of capital, the introduction of new financial strategies to maximize profits and the entrance of billions of new workers from emerging economies into the global labour force, the economic returns of growth have accrued more to capital than to labour, creating greater inequality in most countries.

Inequality and Under-Consumption

What does inequality have to do with economic and financial crises? When the wages of the majority of the workforce are stagnating or kept low, there is a structural tendency towards under-consumption that puts a drag on growth and profit. The production and accumulation process of capitalism is interrupted in the realization process, i.e., goods that are produced cannot be sold due to lack of effective demand from the majority, resulting in excess productive capacity and eventually a slowdown in the economy and economic crisis. In other words, stagnation resulting from under-consumption is inherent in the dynamics of capitalism, reflecting the inability of capital to realize the full value of the commodities produced due to rising income inequality and the falling share of wages over time.[5]

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5. Since Marx's work on capital remained unfinished, the debate is unsettled over whether economic crises are due more to the tendency for the rate of profit to fall arising from the increasing organic composition of capital, or the result of under-consumption in the realization process. In the authors' view, it is not an either/or proposition that can be

Inequality impacts on the economy in two ways. On the one hand, it results in under-consumption or a lack of effective demand for the majority, and on the other hand, it concentrates income and wealth in the hands of a tiny minority with excess savings; the former has a high propensity but low ability to consume, while the latter has a high propensity to save and a strong appetite for investments.[6]

Over-consumption and Debt Bubble, Excess Savings and Asset Bubble

We mentioned earlier how under-consumption in the US was 'resolved' through the assumption of debt by the ordinary households leading to 'over-consumption'. Even as income and wages stagnated, personal consumption in the US rose from about 60 per cent of GDP in 1960s to a peak of 72 per cent in 2007, concomitant with a decline in savings rate of about 10 per cent, supported by household debt that grew 64 times from US$ 216 billion to US$ 13.8 trillion (equivalent to 100 per cent of US GDP). Financial innovations and some government policies[7] fuelled this debt bubble: credit card loans, home equity loans, and securitization of loans exponentially increased the total volume of loans, with the mistaken belief that the dispersion of loans to other investors who are able and willing to bear the risks would make the financial system safer.[8] Home equity loans, in particular, became a major source of income for many, and a driver for the economy. In 2007, home equity loans, totalled US$ 487 billion (Economic Report of the President, 2008: Table B-72). A Federal Reserve calculation showed that net equity extractions from US homes rose from 3 per cent to 9 per cent of disposable income from 2000 to 2006 (cited in Roach, 2009: 59). Another estimate has it that without home equity withdrawals, US GDP growth would have been negative in 2001 and 2002 and less than 1 per cent between 2003 and 2005 (Wikinvest, n.d.). When house prices started to decline in 2006, this boom turned into a bust and triggered the great financial crisis.

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settled theoretically. Rather it is more productive to examine the empirical evidence to discern which trend is more evident in different historical situations, and the myriads of counter-tendencies to these two trends. For a fuller discussion see Sweezy (1946).

6. Krugman (2010), in his discussion on inequality and financial crisis, also talks of under-consumption and debt burden of the ordinary households but attributes the crisis to 'over-consumption' by the upper reaches of society. It is our view that over-investments in financial assets by the rich are more important than their over-consumption of consumer goods in contributing to this crisis.
7. Rajan (2009) attributes a prominent role to government policies to provide housing to the poor through Ginnie Mae and Freddie Mac as an important cause of the crisis. He tends to downplay poor financial practices in this exercise.
8. Alan Greenspan was a major cheerleader for these financial innovations. See his speech 'Risk Transfer and Financial Stability' (2005).

Under-consumption and excess savings are two sides of the same coin. At one end is a majority with limited income and, at the other end, a tiny minority with excess savings and liquidity. As individuals, the rich can only consume so much; most of their income goes into savings and financial investments. They are not content with meagre returns on fixed deposits, particularly in a low interest rate environment. Hence the excess savings are placed in the hands of bankers and financiers who churn out financial instruments to meet the growing demand for higher yields giving rise to the financial asset bubble. However, this debt and asset bubble is a mirage built on what Minsky classified as 'Ponzi' financing, as the escalating household debt is clearly not sustainable given the stagnation in real wages and is built on the assumption that the debt need not be repaid as long as property prices continue to rise to match the growing debt.

Rise and Dominance of Finance Capitalism

While the basic dynamics of capitalism has not changed since Marx wrote his *Capital*, the forms and specifics of capitalism have changed significantly. Among the major changes are the transition from petty-enterprise capitalism to monopoly capitalism and, more recently, the eclipse of the real or productive economy by the financial industry, which has gone way beyond what Marx could have imagined. In the US between 1960 and 2006, the financial sector's share of GDP rose from 14 per cent to 20 per cent of GDP, almost twice as large as the next sector (wholesale and retail trade at 12 per cent), while the manufacturing sector's share fell from 27 per cent to 11 per cent (Economic Report of the President, 1997, 2008). The financial sector accounted for 30 per cent of the share of total corporate profits compared with 21 per cent for the manufacturing sector (Bureau of Economic Analysis, n.d.: Tables 6.16 A–D).

The role of credit and fractional banking is central to the understanding of financial crisis. The GFC and other recent economic crises have shown that fragility and instability in the financial sector are the cause of the most severe financial crises and not wage and consumer price inflation (Barbera, 2009). To the extent that central bankers have focused their eyes on consumer and wage inflation rather than asset inflation, they have been not only remiss in their duty but also misguided in their belief in the hypothesis that markets always price assets efficiently and are self-regulating (see Lim and Lim, 2010: 1–9).

Financial innovations in the financial sector have exaggerated the economic and financial crisis by encouraging practices that reduce the margins of financial safety and increase the risk appetite of investors. In the US inequality and financial speculation encouraged two types of bubbles — a debt bubble among households, certain sectors of industry that engaged in leveraged buy-out, and financial institutions that actively use derivatives to leverage their exposure; and an asset bubble in equities, securities and property.[9] As indicated above, despite stagnating income and wages in the US, households could rack up consumption to its highest level at 72 per cent of GDP. Ironically, the structural trend towards falling share of wages and under-consumption in the US was transformed into over-consumption by the ordinary household (relative to their income) and over-investment by the rich through a financial system that recycled the excess savings of the rich to ordinary households and encouraged excessive risk-taking through innovative financial engineering. The going was good while it lasted, but eventually the party came to an end in 2008.

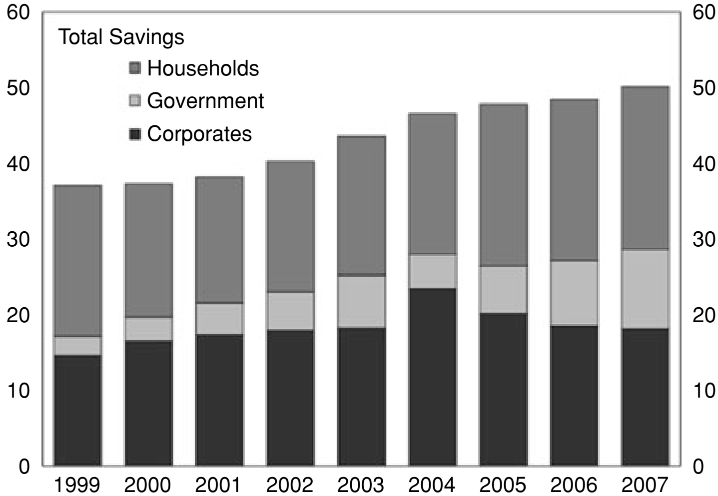
CHINA: INEQUALITY, UNDER-CONSUMPTION AND EXPORT SURPLUS

What about China? China has often been singled out and blamed for the financial crisis because of its huge current account surplus. According to many mainstream economists, the most prominent being Ben Bernanke, the present Chairman of the Federal Reserve System, the 'savings glut' in Asia contributed to the global trade imbalance and low interest rates causing the financial bubble and bust.[10] In discussing the cause of the admittedly unsustainable global current account imbalances, it is disingenuous to pin the responsibility on the current account surplus countries and not the current account deficit countries. From a global perspective, current account surpluses and current account deficits are flip sides of the same coin, i.e. the total value of current account surpluses must be equal to the total value of current account deficits for the world economy as a whole. Hence countries cannot run current account surpluses unless other countries are willing to run current account deficits. Whether a country runs a current account surplus or deficit depends on the aggregate expenditure of the country relative to its income. A country in current account deficit is spending more than its income and can therefore take policy actions to reduce its overall spending in order to reduce its deficit. While China has been accused of pursuing a weak exchange rate policy in order to boost its exports, leading to its current account surplus, the US is equally guilty of pursuing a very loose monetary policy that encouraged the excessive borrowing and consumption by households.

An alternative way to look at the current account balance of a country is its saving investment gap, i.e., an excess of savings over investments is equivalent to a current account surplus, while an excess of investments

9. To the extent that the ordinary and poorer households participated in the housing boom made possible by government mortgage guarantees and securitization, they also helped to fuel the property asset bubble.
10. See his speech, 'The Global Savings Glut and the US Current Account Deficit' (Bernanke, 2005).

Figure 4. Composition of China's Savings, 1999–2007 (as per cent of GDP)



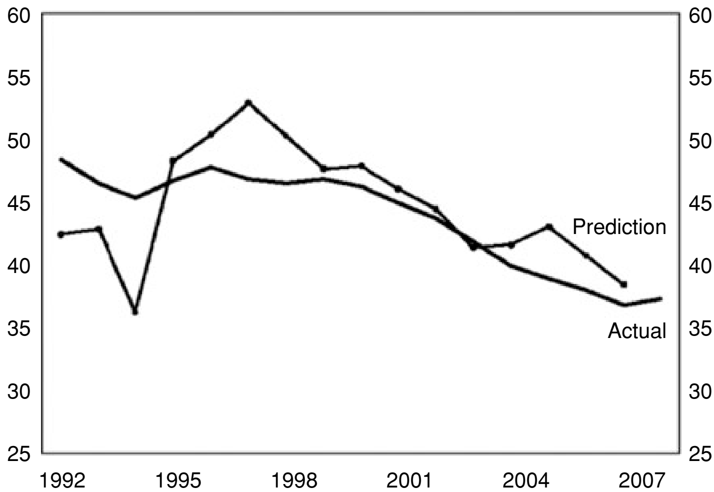
Source: IMF (2010).

over savings results in a current account deficit. From this perspective, the important questions are what causes a country to have more savings than investments, and how can you increase consumption in order to reduce the savings rate for a current account surplus country and vice versa for a deficit country?

Why is China's savings in excess of its domestic investments, causing it to have persistent current account surplus? Figure 4 shows that China has a very high savings rate, close to 50 per cent of its GDP, which is one of the highest in the world. In 2007, the largest component of China's total savings was still the household sector, accounting for about 22 per cent, followed by the corporate sector at 18 per cent and the government sector some way behind at 10 per cent. In national accounting terms, savings is the residual after deducting private and government consumption from gross national income. Hence, the higher the savings rate, the lower the consumption rate. Figure 5 shows that private consumption in China declined from about 50 per cent in 1992 to 36 per cent in 2007, well below the 65 per cent norm for most of the world's major economies; in fact, private consumption was over 70 per cent in the early 1960s in China (Roach, 2009: 179). Why is the private consumption rate low and the savings rate high in China?

Despite the impressive economic growth of China over the last three decades, averaging about 10 per cent yearly, this growth has not been evenly distributed, either from the point of view of the share of GDP accruing to labour or from the perspective of income distribution. Income equality has worsened significantly, with the Gini coefficient almost doubling from 0.32 to 0.50 between 1978 and 2006 (China News, 2009). Another measure of the

Figure 5. China's Private Consumption, 1992–2007 (as per cent of GDP)



Source: Kai and N'Diaye (2010).

imbalance can be seen from the share of GDP going to labour; this dropped from 57 per cent to 37 per cent between 1978 and 2005 (China News, 2010). Roach (2009: 186) says that productivity growth in China surged at an average annual rate of 20 per cent over the 2000–04 period, well in excess of cost pressures implied by the twelve gains in hourly compensation. In other words, like its developed country counterparts, the pendulum in China has swung in favour of capital over labour with most of the productivity gains accruing to capital rather than to labour. With a declining share of economic output accruing to labour, aggravated by increasing inequality of income, private consumption as a percentage of GDP has been declining as shown in Figure 5.

Although real wages of urban Chinese workers in coastal cities have improved and real consumption has risen over time, it is declining as a share of total output. The problem of under-consumption is aggravated by China's reforms that led to a sharp drop in social consumption of goods and services like health care, housing and education. The economic reforms led to the corporatization of state-owned enterprises (SOEs) and a sharp reduction in their provision of social goods and services, as SOEs were encouraged by government policies and compelled by market forces to behave like commercial enterprises and to focus on their bottom line.

There are two major reasons why the savings rate is so high in China. The first is the precautionary saving of ordinary households. Prior to China's economic reforms, social services were provided free or at low prices by the government and SOEs. China was once recognized by the World Health Organization as providing a high level of basic health services (not necessarily technologically sophisticated) to a majority of its population. In the field of education, China improved its literacy rate after the revolution to over 90 per cent and provided good basic education to both men and women, reducing the gender gap. The same can be said for basic housing that was available at very low prices. In the transition from China's variant of socialism to capitalism, millions of state enterprise workers were thrown out of work, social services such as housing, education and health services were drastically cut and economic insecurity mounted for the vast majority of the population. Serious hospital treatments, which used to be free, now cost two years of the average worker's wages. Thus the ordinary Chinese is forced to save for rainy days.

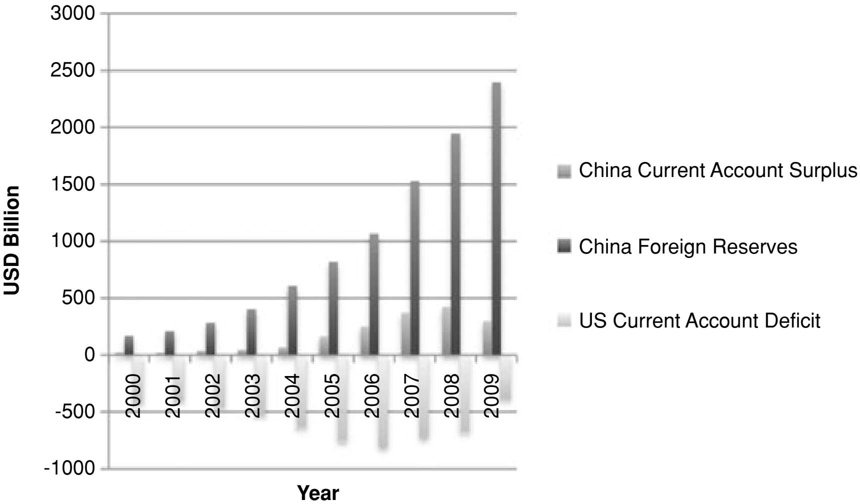
The second source of high savings comes from the corporate sector. The corporate savings rate is high, reflecting in part the behavioural shift of SOEs to maximize profits by cutting back on provision of social services to workers. Furthermore, Chinese SOEs pay very little tax and dividends; most of their profits are used to fund investments, resulting in an extremely high investment rate of about 40 per cent in the Chinese economy. There are two issues with the investments. First, as high as the investment rate is, it is still below the national savings rate, giving rise to an excess of savings over investment. Second, most of the investments are directed at the export sector rather than domestic market, resulting in China's current account surplus (excess of exports over imports).

INEQUALITY, UNDER-CONSUMPTION AND CURRENT ACCOUNT SURPLUS

In both the US and China, inequality results in under-consumption, i.e., a decline in purchasing power for the ordinary households. In the US, however, under-consumption for the ordinary households was 'resolved' by taking on increasing levels of debt. An over-leveraged and sophisticated financial system was able to recycle excess liquidity and on-lend it to households. In China, bank lending to households is not well developed and banks traditionally focus their lending on SOEs. While bank lending to households for consumption and housing has grown in recent years, loans to households still account for only 17.8 per cent of China's financial institutions' total loan portfolio (People's Bank of China, 2008). Instead, the excess savings in China found its outlet in the balance of payments as current account surpluses and rising foreign reserves of the central banks (see Figure 6).

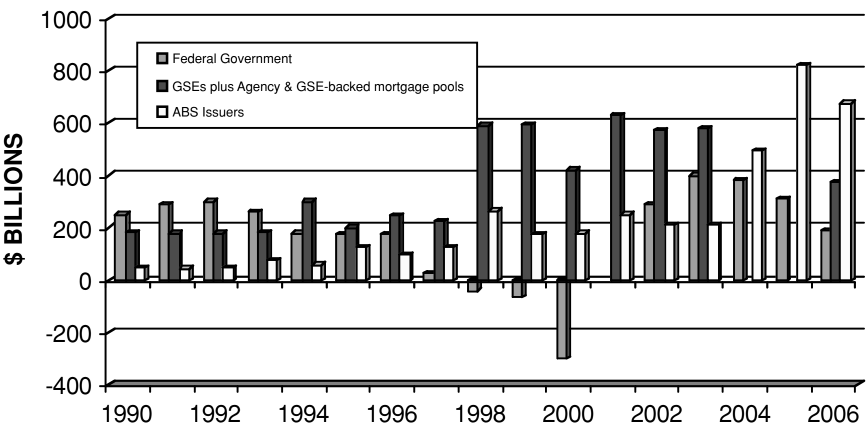
Between 1970 and 2006, exports as a percentage of GDP rose from below 5 per cent to about 35 per cent and together with fixed investments accounted for about 75 per cent of GDP (Roach, 2009: 173). The foreign reserves are mostly invested in US Treasury bills that in turn provided liquidity for the US banking system to lend to the housing sector. Figure 7 shows that the main issuers of debt between 2004 and 2006 were mortgage agencies and

Figure 6. China's and US Current Account Balances, China's Foreign Reserves, 2000–2009



Sources: Bureau of Economic Analysis (n.d.); Chinability (2010); US-China Business Council (n.d.).

Figure 7. US Debt Issuers: Who Issued the Debt?



Source: Duncan (2007).

asset back securities issuers that had overtaken the federal government as debt issuers.

Ironically, under-consumption and excess savings in a poor country like China are funding the excess consumption and debt bubble in the US. To recognize this is not to subscribe to Bernanke's thesis of a global savings glut as the cause of the GFC. World savings as a whole has not risen significantly above historical rates. Rather we see it as a tale of two gluts — the Chinese savings glut, on the one hand, and the US debt and over-consumption glut, on the other hand, made possible by over-leveraged and reckless financial institutions.

The Chinese leaders are concerned about the imbalances in the economy. Premier Wen Jiabao in his press conference after the National People's Congress in 2007 warned that China's economy was increasingly 'unstable, unbalanced, uncoordinated, and unsustainable' (ibid.: 229). The imbalances between the rich and poor and between exports and domestic consumption are not sustainable. Yet, to reduce exports and increase domestic consumption, wages must rise with productivity and inequality must be reduced. The government in recent years has also paid more attention to providing more social services and safety nets to the poor. In the 11th Five Year Plan (2006–2010), the government recognized the need to correct the growing income inequality and imbalance between consumption and investment. It committed itself to expanding domestic demand by raising the incomes of lower- and middle-income households, increasing farmers' incomes, providing more social services to rural areas and accelerating the pace of urbanization, and improving the social security system in order to encourage the Chinese households to reduce their precautionary savings and increase their consumption. However, despite the measures that were taken, the trend towards falling wages and consumption have continued in the last few years and it appears that the government has to intensify its efforts and expand the scope and coverage of its programmes to increase the provision of social goods and services.

CONCLUSION

We return to the basic contradiction in growth under capitalism — that is, the contest for returns between capital and labour. Capital's unrelenting quest for higher profits and returns is at the expense of labour's share, creating the tendency towards under-consumption that in turn threatens the accumulation process. Capital, with the support of the neoliberal state, enacts political, economic and financial strategies to increase its share of the returns. In the US, Europe and other developed countries, this process was aided by the arrival of a huge reservoir of labour from the emerging economies into the global production and labour markets, putting downward pressure on wages and exacerbating the tendency toward under-consumption. The tendency towards under-consumption in the US is overcome by household borrowings reflecting the recycling of the excess savings of the rich minority to the average household. The spread of capitalism into China has also led to a similar phenomenon of falling share of wages and under-consumption by the average household in China. However, the excess savings in China was recycled through the global financial system to the average American household exacerbating the growing debt of US households.

We do not propose that inequality is the only or direct cause of economic and financial crisis. We propose that it is an important factor contributing to financial imbalance in the economy which, combined with a highly leveraged financial sector that churns out new financial products to increase overall lending, increases the vulnerability of the financial system to systemic breakdown. Hence the rising income inequality issue must be addressed in order to resolve economic and financial instability.

Rising income inequality is a structural problem that requires a major shift in policy away from market fundamentalism towards some form of policy to raise real wages concomitant with productivity increases, and to redistribute income from the rich to poor and middle-income households. For now, the priority must be to overcome the financial crisis and restore the health of the economy. However, the difficulty and intractability of dealing with this problem is evident in the present anaemic recovery in the US that may be running out of steam with the end of the fiscal stimulus programme. The stimulus programme has helped to support spending in the economy by providing income to the unemployed, and debt relief to homeowners who have negative home equity. The stimulus programme is meant to be temporary and is effective only if the corporate sector recovers and starts to invest and hire. Although the corporate sector has improved its financial position, it has done so by cutting costs; hence most of the rise in profits is due to cost reduction rather than expansion of business and revenue generation. Cutting costs means not hiring, or making workers work longer and harder. Official unemployment remains at a high of almost 10 per cent. According to McMillion (quoted in Herbert, 2010) 'When you combine the long-term unemployed with those who are dropping out and those who are working part-time because they can't find anything else, it is just far beyond anything we've seen in the job market since the 1930s'; the estimated number in this 'unemployed' group is 30 million.

Even with an improvement in employment, however, economic recovery will still be hobbled by weakness in household balance sheets. For economic recovery to be sustainable, it is necessary for policy makers to address the issues of growth with substantial employment generation, reduction of inequality and strengthening of household balance sheets.

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