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**Recovery Rides on The 'G-2'**

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China's economic growth will plunge in 2009. The United States is in severe recession. For the world's economy to recover, these two economic powerhouses must cooperate and become the engine for the Group of 20. Without a strong G-2, the G-20 will disappoint.

We must address realities. The root cause of broader global payment imbalances is structural: overconsumption in the United States and oversaving in China. For the United States, the consumption boom was fueled by bubbles in stocks and housing. This was accompanied by a collapse in the U.S. savings rate. For China, the savings surplus is a result of structural distortions in the financial, corporate and resource sectors.

China's savings rates, at up to half of its gross domestic product, are much higher than in other countries. But this is not all because of workers saving money. Indeed, household savings in China are about 20 percent of GDP, similar to the rate in India. An unusually high amount of savings comes from large companies in China's corporate sector. Small and medium-size enterprises, which employ 80 percent of workers, have minimal access to financial services because that sector is dominated by four large banks that primarily serve large companies. The smaller businesses' lack of access to financial services retards their growth, curbs employment and exerts downward pressure on wages. In effect, the skewed financial structure in China means that ordinary people and small and medium-size companies have been subsidizing big corporations and the new rich through low wages and interest rates.

A revaluation of China's currency -- a change in relative prices -- is not the primary tool for addressing these structural problems and the imbalances they have produced. In fact, economic diplomacy between the United States and China should focus on two other areas.

First, the two countries should join forces to prevent a protracted global recession. Both countries have announced stimulus packages. The United States is again relying on boosting consumption, and China is again channeling funds to investment. While this is a natural response to the immediate concerns, over time the United States must boost savings and investment while China increases consumption, not just capacity. China is preparing a second stimulus, which should focus on creating purchasing power for poorer consumers as well as building "soft infrastructure" in service industries and "hard infrastructure" to reduce growth bottlenecks (which would in turn increase productivity). China could also clean up environmental damage caused by underpricing resources. For its part, the United States should persist with monetary, credit and asset restructuring policies to reboot the financial system so its stimulus has a chance to work. Both must resist protectionism and assist the vulnerable in poor countries.

Second, the strategic economic dialogue between China and the United States should focus on how to reduce the structural consumption-savings imbalances in both economies. To achieve its leaders' goal of building a "harmonious society," China needs to improve its income distribution. The next stage of Chinese reforms should boost social security protections, wages, service-sector efficiencies, and "green" resource-pricing and businesses -- all of which can increase consumption and imports. In particular, China should promote the local banking sector to better serve small and medium-size enterprises, including through microfinance lenders. It should open up oligopolies, such as in telecommunications, to competition. Further liberalization in trade and investment in services would make China's markets more competitive and productive, and it would reduce trade tensions. Without greater imports, China faces the risk of adjustment solely through a sharp and painful fall in exports.

The United States, in turn, must rebalance saving and consumption. It cannot afford a return to the days of maxing out credit cards to finance unfettered consumption. It must regain control over expanding budget deficits, which are driven largely by entitlement spending. It also needs investments in education, research and development, and technology -- with continued openness to investment, goods, ideas and talented people -- to remain the world's leading economy.

Such adjustments would go a long way toward reducing the risk of global economic turmoil. There are strong mutual incentives: The United States is the largest destination for Chinese exports, and China is the largest foreign investor in U.S. government debt. The economic interdependency is stark.

The imbalances in the Chinese and U.S. economies can only be tackled gradually. Yet they must be addressed. A recovery based on boosting U.S. consumption and providing easy money financed by overseas savings would result in a repeat of mistakes, with dangerous consequences for global markets and politics. Even as the United States and China lead the way toward today's solution, they need to be shaping tomorrow's world economy.

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