effective harmonized rules leads the author to consider possible 'pragmatic solutions' for arriving at a consensus.[26] But these too are found wanting due to the challenges of identifying common ground in any multilateral negotiations involving a large and diverse group of sovereign states. Rigorous cost–benefit analysis of proposed regulatory approaches is posited as one possible solution, but the author ultimately concludes that the practical difficulties of conducting such analysis are at present insurmountable. The reader is thus left to hope that 'better data and a stronger theory will make a difference in the future'.[27]

Taken as a whole, the remarkable collection of papers assembled by Drabek and Mavroidis succeeds both in identifying and explaining in clear terms the most salient questions in the regulation of foreign investment today. Considering the complexity of these questions, it is not surprising that these papers are less successful in offering convincing answers as to the best way forward. The reader will be conscious of a general bias – one which is explicit in the title of this collection – in favor of more regulation and greater international harmonization. Whether or not one shares this perspective, the diversity of themes covered in this book make it essential reading for anyone interested in an accessible overview of the latest developments in the regulation of foreign investment.

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The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy

by Michael Pettis

Princeton, NJ: Princeton University Press, 2013

Those who believe global trade imbalances were the cause of the great recession will find much to like in *The Great Rebalancing*. The book sets out to demystify global imbalances, explaining their role in the distribution of growth around the world. It succeeds in debunking the myth that surplus countries are virtuous and thrifty, while deficit countries are dissolute and profligate. It explains how instead surpluses and deficits are driven by government policies at home and abroad. It also refutes the prevailing wisdom that the dollar's role as a reserve currency is an exorbitant privilege; rather, it is an exorbitant burden because it puts thousands of US jobs in the hands of dollar reserve hoarders. The book places global imbalances squarely at the center of both the global financial crisis and the Euro crisis, and promotes rebalancing as critical for global growth and stability. It will help an educated reader understand why

26 Chapter 13, p. 480.

27 Chapter 13, p. 481.

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financial repression in China matters for US jobs, why the Euro benefitted Germany at the expense of Southern Europe, and how trade imbalances fed into the global crisis.

The analytical framework is basic open economy macro, though Pettis chooses to avoid equations or graphs, presumably to target a broader audience of policy makers and educated readers of magazines like the *New Yorker* or the *Economist*. This is an ambitious goal for a complex topic, and the narrative comes across at times as too simplistic for economists, and, at others, probably too dense for the layman. Those who have completed undergraduate coursework in economics will find the extensive text required to serve in the place of more elegant equations somewhat exhausting. Only two simple identities are needed to understand his book:

$$Y = C + I + G + X - M, \tag{1}$$

where Y is income, C is consumption, I is investment, G is government spending, X is exports, and M is imports. Rewriting this equation yields:

$$S - I = X - M, \tag{2}$$

where S is savings. Overall, I am not convinced that the educated reader would not be better served by including these two equations to help navigate the text, which then could be shortened significantly.

Using these identities, the first point is that, by definition, trade imbalances are driven by savings and investment, thus imbalances can only be narrowed if savings fall or investment rises in surplus countries and the reverse happens in deficit countries. Since a country's savings are income that is not consumed by either households or the government, policies that affect consumption effectively determine the trade balance.

Pettis uses this framework to clarify the relationships between China and the US and the relationship between Germany and the Euro periphery. China and Germany both have suppressed domestic consumption, importing demand from abroad, which has enabled them to grow faster. China did this by financial repression and currency manipulation, while in Germany it happened as a by-product of the Euro, which led to undervaluation in Germany with respect to the southern rim. By virtue of undervaluation, consumers in China and Germany find imports relatively more expensive and consume less, savings expand and, voilà, they have surpluses. In turn, since their net exports are the rest of the world's net imports, their trade partners with overvalued currencies are forced to hold deficits through no fault of their own.

The deficit countries, by definition, must either consume more or invest more to absorb the capital. To the extent that consumption in deficit countries drives domestic growth, it can last for some time, but debt will build up. If instead investment soars, it is fine so long as it is in productive sectors and contributes to future growth. Pettis argues, however, that the overvalued currency associated with the deficit leads to a relatively less competitive tradable sector, such that investment is very likely to fund a real estate bubble.

Exposing the flaw in linking moral values to trade balances, and highlighting the distortions caused by China's and Germany's domestic policies as the chief culprit, is valuable. But it is puzzling that Pettis does not pin more of the blame for the ongoing crisis on governments in the big deficit countries. While the US had access to cheap foreign capital, the government failed to rebuild airports, bridges, and roads – investments that would have supported future growth. Despite clear signs of stress, the US also failed to properly regulate the financial sector. Similarly, cheap money in Greece led to rising government wages and apathy about tax reform. It was the combination of the savings glut and poor governance that generated the massive financial crisis and the Euro mess.

An important contribution along the way is explaining China's growth strategy, its limits, and the need for rebalancing. Suppressing domestic consumption has been effective in stimulating the tradable sector and producing high growth rates, but has also starved households at the benefit of the state. Pettis argues that the investment-heavy stimulus in the aftermath of the financial crisis was problematic because it forced much of the adjustment on the rest of the world and would be hard to sustain. As the stimulus has now run its course, and China suffers from lagging construction spending, his concerns have been validated. The book repeatedly emphasizes the need for China to stimulate consumption. This would be good for Chinese households, Chinese stability, and the rest of the world.

Pettis offers a sharp discussion of the unique role of the dollar as a reserve currency. While others have criticized this exorbitant privilege – a privilege that other countries repeatedly refused to share – he argues that printing the world's currency has become an inordinate burden. The basic intuition is that, in the current environment of weak global growth, the status of the US dollar as a reserve currency is forcing the US to hold deficits and export demand to the rest of the world. While this is a valid point, a more nuanced discussion of under what conditions, and when in the past, the exorbitant privilege may have held would have enriched the text.

Trade economists will find that the book does not satisfactorily address the relationship between trade policy and either bilateral or overall trade balances. Pettis repeatedly equates trade policy to exchange rate adjustments in their ability to influence surpluses. He rightly points out that tariffs influence trade balances only through their effect on savings or investment, but he then vastly overstates the importance of this channel by assuming tariff revenue is saved. In general, tariff revenue is redistributed to the public either through public investment or lower taxes and hence does not feed very much if at all into saving. Higher trade barriers distort consumption and reduce welfare. They also prevent supply chains from functioning and have anti-competitive effects. In contrast, exchange rate movements affect real household income and the incentives to invest in the tradable sector. Unlike exchange rate movements, which are strongly correlated with current account adjustment in a cross section of countries, higher tariffs are far more common in deficit countries. The text is muddled on this point: on the one hand, it correctly underscores that a shopping trip by Chinese officials of big ticket items in the US will do nothing for trade balances; on the other hand, it fails to recognize that this effective Chinese import subsidy on US goods is akin to lowering the Chinese tariff on US goods. This omission is unfortunate because it misses an opportunity to explain why trade barriers are not the appropriate tool to address global imbalances.

Pettis ends with predictions about the future. Making predictions in international economics is, of course, risky business. The most controversial ones at the time of writing were probably (1) that without fiscal union or German rebalancing, peripheral

Europe will abandon the Euro and (2) that China is in for slower growth of 3–4%, as the investment-heavy stimulus is unsustainable. On (1), with the benefit of an additional year's hindsight, Southern Europe instead seems to have opted for a protracted period of painful unemployment and falling wages, and the Euro will survive. On (2), Pettis points out that 3–4% growth will be viable provided it is associated with a transfer of income from the state to households. This is very doable – given past policies of starving households for the state and high growth. The recent slowdown in China, especially on construction, supports his prediction. However, it still seems unlikely that growth will fall below 5%.

Pettis does a major service in explaining the determinants of global imbalances, providing insights into the functioning of the Chinese economy, while bringing in quotes from historical figures, prominent economists, and misguided pundits. This serves the purpose of underscoring how confused thinking can be on this important topic – a topic that ultimately helps determine the distribution of growth and jobs around the globe. I hope this book stimulates a more informed debate on how to rebalance growth, trade, and capital flows in the least disruptive manner. His final sentences quote Lewis Carroll, offering a cautionary tale about our prospects. After Alice asks which way to go to 'get somewhere', the Cheshire Cat advises that 'you are sure to do that,' ... 'if you only walk long enough'.

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