*Leiden Journal of International Law* (2021), **34**, 1011–1015
doi:10.1017/S0922156521000455

BOOK REVIEW

Matthew C. Klein and Michael Pettis, *Trade Wars Are Class Wars: How Rising Inequality Distorts the Global Economy and Threatens International Peace*, Yale University Press, 2020, 288 pp, $28.00, ISBN: 9780300244175
doi:10.1017/S0922156521000455

In recent years, the opposition to trade liberalization and globalization of capital markets has increased. It also led to the popularity of the 'Trump narrative',[1] coined by Lamp regarding the winners and losers in economic globalization. According to this narrative, workers are engaged in a zero-sum competition over jobs: the workers in trade surplus countries such as China 'steal' the jobs of the workers in the US, a deficit country. Hence, the new book *Trade Wars Are Class Wars: How Rising Inequality Distorts the Global Economy and Threatens International Peace*, authored by Matthew C. Klein, the economics commentator at Barron's, and Michael Pettis, Professor of finance at Peking University's Guanghua School of Management, is a timely must-read for anyone who is interested in discovering some real causes of trade wars, and seeking an answer to the question: 'who are the winners and losers of economic globalization'.

The authors posit that trade war is, in essence, a conflict between bankers and owners of financial assets on one side and ordinary households on the other.[2] As Pettis stated in an interview, 'trade cost and trade conflict don't reflect differences in the cost of production; what they reflect is a difference in saving imbalances, primarily driven by the distortions in the distribution of income'.[3] This book attempts to show that the workers in both surplus and deficit countries are the losers in our existing global trade and financial system, and the winners are the rich elites who accumulate considerable financial assets and contribute to the failure of international capital to go where it is needed in forms that are useful.[4] Specifically, the purchasing power of the rich with higher saving rates is shifted from goods and services to financial assets, and everyone else is deprived of income they could have used to buy additional imports, which result in the inequalities within countries.[5]

Although international trade and investment have important implications for the distribution of wealth and power among nations, the role of international financial system shall not be ignored.

[1]N. Lamp, 'How Should We Think About the Winners and Losers from Globalization? Three Narratives and Their Implications for the Redesign of International Economic Agreements', (2019) 30(4) *European Journal of International Law* 1359.

[2]M. C. Klein and M. Pettis, *Trade Wars Are Class Wars: How Rising Inequality Distorts the Global Economy and Threatens International Peace* (2020), at 221.

[3]A. Tooze, 'Trade wars are class wars', *Phenomenal World*, 13 June 2020, available at phenomenalworld.org/interviews/trade-wars-are-class-wars.

[4]Klein and Pettis, *supra* note 2, at 88–9.

[5]Ibid.

As Strange argues, it is finance, not trade, that really sets the terms of globalization.[6] This view is also reflected in the analysis of Klein and Pettis, when establishing the theoretical foundation in the first three chapters, through addressing the role of global financial system in contributing to the shaping of trade surplus and deficit countries, and the inequalities between the rich and the working class. By tying the global trade system and financial system, and exploring the interaction among production, consumption and savings, they state that 'the net amount of money coming in or going out via the financial account must equal the net amount of money moving across a country's borders as recorded in the current account'.[7] Then, they examine how financial imbalances determine trade imbalances.

In the fourth and fifth chapters, Klein and Pettis conduct a comparative analysis of China and Germany, demonstrating how the rich elites in these two surplus countries accumulate excess savings and impose burdens on the rest of the world to absorb large 'gluts'[8] they create.[9] To respond to the under-consumption, the rest of the world has to absorb these additional goods or services through less saving and more spending or enduring a slump caused by insufficient global demand.[10] Also, the authors give a cogent explanation about how Germany overcame its domestic weaknesses – the declined domestic spending with limited rise in corporate profits – by selling to customers in other Southern Eurozone economies, and contributed to the Euro crisis.[11] Specifically, German under-consumption and under-investment drive the pre-crisis lending booms, led by German banks, which contributes to excessive borrowing by what would become Europe's crisis countries. Given the membership in the Euro area, the crisis countries lack standard monetary tools for managing business cycles, which places them in a precarious situation.[12] Finally, the authors look into the US, as a trade deficit country facing the burden of responding to voracious demand for low-risk US fixed income, and explain how this burden, combined with the failure of the federal government in issuing enough debt to meet that demand, contributed to America's debt bubble and de-industrialization.

As a student focusing on international economic law and policy, I explore the implications of the thought-provoking analysis presented in this book, in terms of reassessing and addressing the flaws in our international economic governance. To this end, three main issues are discussed below.

## 1. A lack of motivation for domestic reform: Do losers realize they are losers?

Klein and Pettis offer a range of prescriptions targeting the redistribution policies in surplus economies in response to the real causes of trade wars. Specifically, the Chinese government is advised to reform the *hukou* system, improve the quality of social security, and grant collective bargaining power to workers.[13] Also, innovative methods could be explored to fix Europe's fiscal position by,

[6] S. Strange, *Casino Capitalism* (1986). See also T. Piketty, *Capital in the Twenty-First Century* (2014).

[7] Klein and Pettis, *supra* note 2, at 85.

[8] Ibid., at 68.

[9] While the rich may spend more on luxury goods and services that workers and pensioners cannot afford, most savings are spent on financial assets with high returns, which may also lead to less investment in real economy for example infrastructure projects in many countries.

[10] Klein and Pettis, *supra* note 2, at 68.

[11] Ibid., at 159.

[12] Ibid., at 164. The analysis of Klein and Pettis about German under-consumption and German banks' over-lending is part of the Euro crisis tale. Joseph Stiglitz points out that a range of measures, including austerity and bailouts in response to the Euro crisis, were directed towards the protection of the interests of large financial institutions, mostly in surplus countries, rather than workers in crisis countries, which became another key externality contributing to the Euro crisis. See J. E. Stiglitz, *The Euro: How A Common Currency Threatens the Future of Europe* (2016). See also R. Howse, 'Economics for Progressive International Lawyers: A Review Essay', (2017) 5(1) *London Review of International Law* 187.

[13] Klein and Pettis, *supra* note 2, at 229.

https://doi.org/10.1017/S0922156521000455 Published online by Cambridge University Press

for example, federalizing European fiscal policy.[14] According to the authors, surplus countries should take on the responsibility of saving the losers – the working-class people in both trade surplus and deficit countries. While there is an urgent need to reform domestic policies of surplus countries with significant spillovers, an exclusive focus on them may not achieve a big difference. Moreover, the lack of motivation to reform may become a significant barrier to improving the current situation.

In the case of China, Klein and Pettis refer to a group of 'vested interests',[15] which have benefitted considerably from China's high-saving development model, as the obstacle to the wealth redistribution reforms. However, whether the losers regard themselves as losers remains questionable. As the authors illustrate, China's rapid growth helps to hide the enormous amount of wealth being transferred from ordinary Chinese workers and retirees to the elite group. The fact that household incomes increased rapidly even as Chinese households consumed smaller and smaller shares of the Chinese economy's output,[16] may make most Chinese households see themselves as the beneficiaries of the previous development model, while recognizing that redistribution needs some adjustments. Also, as the US-China trade war escalates and the 'Trump narrative' about a zero-sum competition on jobs between workers from deficit and surplus countries prevails, domestic reforms may become more difficult. In particular, some domestic reforms such as economic restructuring and income redistribution could have negative side effects on employment (even during a temporary transition period). For example, the transition to green industry could see a decline of coal industry as well as weaken the 'vested interests' which have relied heavily on the development of the coal industry. However, in the initial stage, it would also harm the interests of employees in this sector. Such reform might be interpreted as China's failure to respond to the trade war, which reduces foreign demands for Chinese products and creates jobs for American workers at the expense of their Chinese counterparts, and therefore would encounter some resistance.

## 2. The return of industrial policies

Although the main concern of Klein and Pettis is not the design of a new global economic governance, nevertheless their analysis offers several valuable guidelines on this issue, particularly in regard to international regulations on subsidies. In discussing what America should do, Klein and Pettis believe that it is important to maintain a domestic industrial base 'despite the distortion caused by underpinning in the rest of the world'.[17] The US federal government is advised to absorb foreign financial flows to increase investment in much-needed American infrastructure and direct spending to sustaining demand for American products.[18] This suggestion seems to imply the establishment of industrial policies or subsidies to support American domestic manufacturers, considering that only such policy could work for a domestic market, which is facing a large 'glut'[19] in the form of manufactured goods from abroad.

Many eminent scholars have explored what kinds of industrial policies promote job growth, new industry etc., for different economies.[20] What I would like to address is the important role of a new international agreement on subsidies in an era of the coming-back of industrial policies in both developed and developing economies. Currently, the WTO Agreement on Subsidies and Countervailing Measures (SCM) establishes multilateral disciplines on the use of subsidies. In January 2020, the trade ministers of the US, Japan and the EU proposed a trilateral initiative

[14] Ibid., at 231.
[15] Ibid., at 104.
[16] Ibid., at 108.
[17] Ibid., at 227.
[18] Ibid.
[19] Ibid., at 68.
[20] D. Rodrik, 'Industrial Policy: Don't Ask Why, Ask How', (2008) *Demo issue Middle East Development Journal* 1.

to reform the WTO rules on subsidies, state-owned enterprises (SOEs), and forced transfer of technology. However, as Howse argues, by insisting on neoliberalism and regarding subsidies as market distortion, the initiative ignores the role of subsidies in correcting market failures and pursuing nonmarket goals.[21] Klein and Pettis also show that even the US, which played a major role in establishing the Washington Consensus rules, may need to reconsider its industrial policies and their implications for sustainable development. It is expected that the world will see an era where the importance of industrial policies is reconsidered and further explored in many economies. For example, while a consensus has been achieved on the need for combatting climate change, the transition to a green economy is still facing a range of challenges in practice. Specifically, many private firms could not bear the risks of investing in technological development. Also, new green technologies may fail to compete with incumbent technologies, which create path-dependencies for an economy. To address them, industrial policies are indispensable for creating a new market for the development of green technologies, especially for a post-pandemic era, in which recovery strategies are being formulated and the future path is set.

Therefore, the SCM Agreement should reflect and incorporate the need for more policy space of its members in designing their own subsidies policies, especially green subsidies, and incorporating them into WTO rules. More importantly, as an international agreement with a coordination role, the SCM Agreement should aim to prevent a country's subsidy measures from harming the people of other countries. This approach is proposed by the US-China Policy Working Group, which might be more desirable in reflecting a rising trend of using subsidies and achieving international peace.

## 3. A new approach to the rising power

What is noteworthy in Klein and Pettis' analysis is that they trace the roots of global economics to a series of complicated events, which are usually seen as geopolitical conflicts. For example, they claim that China's Belt & Road Initiative (BRI) is a means of managing the trade-offs associated with its internal rebalancing, rather than as a part of some strategic plan to acquire territory or military bases.[22] However, the BRI does have geopolitical influences since it took off and expanded across the border. Moreover, global responses to the BRI could not separate from geopolitical considerations. In other words, if we focus only on fixing the domestic distribution problem of the Chinese economy, which led to the establishment of the BRI, it might be difficult to fully deal with the broader geopolitical impacts that the BRI has with its further development. Also, the authors regard China and Germany, the two major trade surplus countries, as the contributors to increasing the inequalities underlying trade wars.[23] However, it must be considered that the global responses to these two surplus countries would be different based on several geopolitical concerns, especially since China is a rising power while Germany is an established power and a member of the EU. Therefore, while recognizing the economics-based causes of today's trade wars, the policy design for addressing them still needs to take into account several geopolitical factors.

Klein and Pettis also offer some valuable reflections to exploring an appropriate approach to a rising power by looking into Great Britain and the US, as rising powers in the early nineteenth century and after the Second World War when the Bretton Woods system was established respectively, in terms of their lending and borrowing practices and their implications for the rest of the world.[24] What lessons can be learned from these two countries and applied to China, as a current rising power, which lends to the rest of the world, especially the BRI countries? Two issues could

[21] R. Howse, 'Making the WTO (Not So) Great Again: The Case Against Responding to the Trump Trade Agenda through Reform of WTO Rules on Subsidies and State Enterprises', (2020) 23(2) *Journal of International Economic Law* 1.

[22] Klein and Pettis, *supra* note 2, at 124.

[23] Ibid., at 68.

[24] Ibid., at 46–55, 50, 124, 190, 218.

be addressed. First, to externalize its domestic imbalances, mainly in the form of exporting overcapacity to the rest of the world might be the only alternative that a rising power has when accumulating excess savings from its previous development. While it would impose negative spill-overs on the other countries, closing the channels it uses for transferring its domestic burdens might cost more (and even leads to wars) than accommodating these spill-overs. Second, effective global governance could be established with the goal of reducing these negative spill-overs. Taking the BRI-related projects as an example, Klein and Pettis express their concerns that by exporting China's domestic development model to BRI countries, Chinese lenders have less incentive to exercise due diligence, which may cause a raft of bad debts,[25] and even wasteful investments considering the limited capacity of small countries to absorb too much financial capital. Hence, it is necessary to establish relevant global mechanisms for assessing the loans granted and the value of specific BRI investments, and to ensure debt sustainability in BRI countries as a way of reducing the negative spill-overs caused by a rising power. Rather than stopping or disrupting these projects, placing them within a global regulatory framework may bring the world closer to peace.

What is worth examining more systematically in the authors' analysis about China's development model is state capitalism, which has been accepted by many other economies. SOEs have operated in virtually every country and become dominant in key sectors.[26] Also, a new form of state capitalism – sovereign wealth funds (SWFs) – has become prevalent around the world. Having transformed from a passive asset owner to an active investor, the SWF poses more complicated challenges to current international economic orders than SOEs. For example, how could we deal with the increasingly obscured line between economic interests and political goals in the operation of an SWF, and what are appropriate regulatory responses to it? What impacts will SWFs bring about, considering that they have developed a range of new cooperative arrangements with private investors in key sectors? More importantly, in facing the come-back of state capitalism, how should international economic orders be reformed so as to improve people's lives and reduce inequalities, rather than simply regarding them as inefficient state intervention into the market? Exploring answers to these questions not only helps to find an appropriate approach to the rising China, whose economic development model could be featured by state capitalism, but could contribute to better international economic orders which could accommodate the interests of countries with diverse development models.

Klein and Pettis' excellent book not only encourages us to reflect on economic globalization which operates at the expense of ordinary working people in both deficit and surplus countries in past decades, but also offers valuable insights in regard to new international economic orders that should be established. This review is conducted from the perspective of a student whose main academic interest is international economic law and policy. However, I highly recommend this book to anyone interested in international trade and finance.

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[25] Ibid., at 125.

[26] International Monetary Fund, *Policies to Support People during the Covid-19 Pandemic* (2020), Fiscal Monitor No. 2020/001, Ch. 3.

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