

Chapter 1

INTRODUCTION

The Main Argument

In 2007–2008, a speculative bubble in the US housing market exploded sending the US economy, and soon thereafter the European economy, into crisis. Unemployment skyrocketed. For example, unemployment in the USA jumped from 4.6% in 2007 to 9.6% in 2010 and then fell to 8.1% in 2012. The United Kingdom’s unemployment rate of 5.4% in 2007 rose to 7.9% in 2010 and then has stayed in the range of 7.9–8.1% between 2010 and 2012. Italy’s unemployment, which was 6.2% in 2007, has continued to rise hitting 10.8% in 2012. Spain’s unemployment, which was 8.3% in 2007, has continued to rise hitting 25.2% in 2012 (<http://www.bls.gov/flscompare/lf/lfcompdiur>). In response to this crisis, central banks have increased their money supplies by unprecedented amounts (Lauricella *et al.*, 2012; Mead and Hilsenrath, 2013). Meanwhile, concerned about growing budget deficits, governments are cutting spending and increasing taxes. As the resulting fiscal austerity makes the recession worse and as the effects of increasing the money supply diminish, governments (especially European governments) cling to the hope that internal devaluations (a euphemism for cutting wages and reducing labor power) will result in increased exports and a return to export-driven growth.

China’s stated government goals stand in stark contrast to these trends. China does not want to return to an export-driven growth model; instead, it wants to establish a domestic consumption-driven growth model. According to Orlik (2013), manufacturing wages in China have risen by 71% between 2008 and 2013 while average private sector wages rose 12.3% in 2011

1 and 14% in 2012. However, to successfully establish a consumption-driven
2 growth model, China must do more than just allow wages to rise. China must
3 solve some major problems in its health care, pension, banking, and court
4 systems; furthermore, China needs to address problems due to corruption,
5 its growing inequality, and insufficient competition.

6 Which strategy is best — is it best to embrace the European goal
7 of restarting export-driven growth via internal devaluations or is it best
8 to embrace China's current goal of establishing a domestic consumption-
9 driven growth model? The economic future of the world depends on how
10 this question is answered. The correct answer to this question depends on
11 the fundamental cause of the current crisis.

12 This book will show that the fundamental cause of the current crisis
13 is a global surplus of savings which is either (1) sitting idle, (2) seeking
14 a return by earning rents or by deception in contrast to seeking a return
15 by expanding production, or (3) funding speculative bubbles. Successful
16 production expanding investment requires two things: (1) there must be
17 savings to fund the investment and (2) there must be the reasonable hope
18 that what that investment produces can be sold. In other words, there must
19 be sufficient consumption to provide a reason to invest. There is a global
20 surplus of savings because there is currently insufficient consumption to
21 justify production expanding investment.

22 The European approach to the crisis — internal devaluations that reduce
23 wages — reduces worldwide consumption and, thus, the reason to invest.
24 Internal devaluations will make the worldwide crisis worse. Granted if
25 Spain, for example, can reduce its wages more than all other countries, then
26 Spain will probably be able to drive its economy off of increased exports;
27 however, the world will lose more than Spain gains due to a net fall in
28 worldwide consumption and a net increase in the global surplus of savings.
29 China has the right idea — what the world needs is more consumption,
30 not less.

31 Consider some key elements of the above thesis.

32 **A Global Surplus of Savings**

33 US corporate cash holdings fell from US\$1.53 trillion in 2007 to
34 US\$1.39 trillion in 2008 but jumped to US\$2.05 trillion of cash and other

1 liquid assets by June of 2011 which is the highest amount of US corporate
2 cash since 1963 (Monga, 2011; see also Casselman, 2012 and Chasan,
3 2013). “Corporate cash holdings are now €2 trillion (US\$2.64 trillion)
4 across the euro zone and an extraordinary £750 billion (US\$1.19 trillion) in
5 the UK” (Fidler, 2012). The Institute of International Finance estimated that
6 in January 2012 “corporations in the USA, the euro zone, the UK, and Japan
7 held some US\$ 7.75 trillion in cash, or near equivalents, an unprecedented
8 sum” (Fidler, 2012).

9 Meanwhile, according to Simon Tilford (chief economist at the Centre
10 for European Reform) “the ratio of investment to gross domestic product
11 (GDP) in Europe is at a 60-year low” (Fidler, 2012). According to the rating
12 agency Standard & Poor’s, US corporations cut investment by an estimated
13 US\$175 billion between 2009 and 2011 which boosted their cash reserves
14 (Gara, 2012). Instead of investing their cash in expanding production, US
15 corporations “announced plans to buy back US\$117.8 billion of their own
16 shares in February [2013], the highest monthly total in records that date
17 back to 1985.” In 2013, “companies in the S&P 500 index are expected
18 to pay at least US\$300 billion in dividends . . . which would top last year’s
19 record of US\$282 billion” (Demos *et al.*, 2013). It is as if corporations are
20 willing to sit on their cash, use their cash to buy back their own stock, or
21 use their cash to pay greater dividends; in other words, they are willing to
22 do anything with their cash except invest it in expanding production.

23 Banks are also accumulating cash reserves. By the end of 2012, US
24 bank deposits hit a record US\$10.6 trillion; meanwhile, the loan-to-deposit
25 ratio has fallen from 95% in 2007 to 72%. Since 2008, outstanding loans at
26 US thrifts and banks have fallen 5.3% (Sidel, 2013). Commercial Japanese
27 bank deposits at the Central Bank of Japan increased 113% between March
28 and November 2013. Furthermore, the loan to deposit gap for Japanese
29 commercial banks has widened by 8% per year on average for the last
30 10 years. “Loans at Japanese banks amounted to 69% of deposits at the end
31 of October” 2013 (Dvorak and Warnock, 2013a). Deposits are up while
32 loans are down in spite of interest rates approaching 0%.

33 One of the primary ways that governments save is by accumulating
34 foreign reserves. Figure 1.1 shows that world holdings of foreign reserves
35 increased relatively steadily from 5.55 trillion in 1976 to 37.87 trillion in
36 2001. In 2001, the world dramatically increased its accumulation of foreign

First Proofs (not for sale) for *The Limits of Fiscal, Monetary, and Trade Policies* by Jonathan E. Leightner
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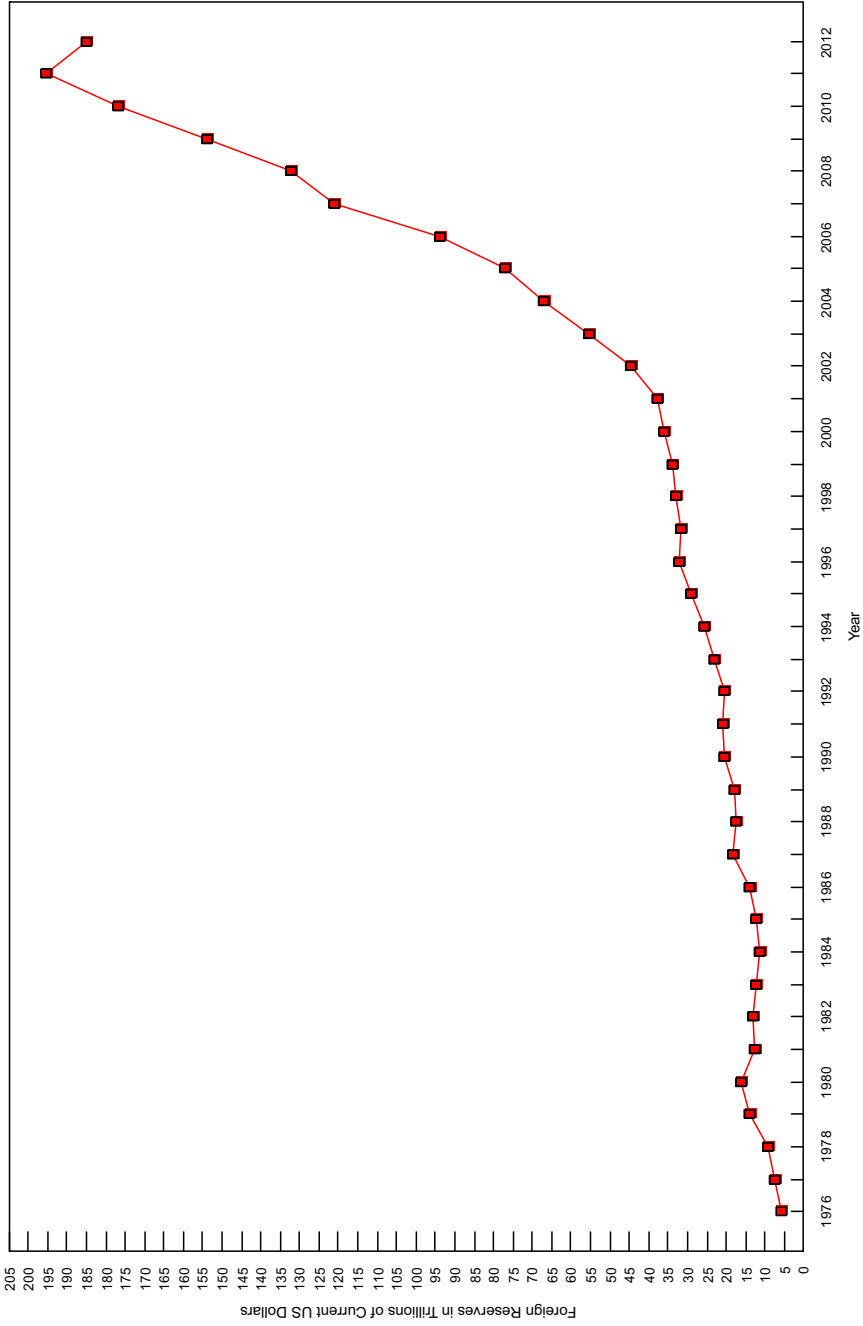


Figure 1.1: The World's Holdings of Foreign Reserves

1 reserves. By 2011, foreign reserves were 195.41 trillion, although they fell
2 in 2012 to US\$184.92 trillion. In the 35 years between 1976 and 2011,
3 world holdings of foreign reserves grew 34-fold.

4 Figure 1.2 shows the holdings of foreign reserves by the eight coun-
5 tries that held the most foreign reserves in 2011. Between 1979 and 1994,
6 the USA had the most foreign reserves. These reserves slowly grew to
7 US\$294 billion in 2008, jumped to 404 billion in 2009, grew to 537 billion
8 in 2011, and then plummeted to 139 billion in 2012. China's foreign reserves
9 were 172 billion in 2000 but grew to US\$3,663 billion by September
10 2013 for a 20.3-fold increase in 13 years. Japan's holdings of foreign
11 reserves increased from 80 billion in 1992 to 1,227 billion in 2012 for
12 a 14-fold increase in 20 years. Governments, corporations, and banks have
13 all increased their savings in the last two decades.

14 **The Qualitative Difference between a Return** 15 **from Investment Based on Owning versus** 16 **a Return Based on Expanding Production**

17 If I earn a return from owning something — a house, a business, treasury
18 bonds, or foreign currency — then my return is someone else's loss.¹ The
19 renter of my house loses the money that I gain. The person who sold me the
20 business loses the future income stream from the business. The government
21 loses the interest they pay on the Treasury bonds. In contrast, if I earn a
22 return based on expanded production, then the total wealth generated in
23 the world has increased and there is the possibility that everyone gains.
24 Admittedly, the line between earning a return from owning and earning
25 a return from expanding production can be blurred because the money
26 I paid for a treasury bond might be used to build a new road that increases
27 the production capabilities of my country. However, this distinction is still
28 useful especially in a world where there is currently very little investment
29 in expanding production and a large amount of investment that aims at
30 earning a return from rent. Many experts trace the beginning of the crisis

¹A part of my return is compensation for my bearing risk; however, usually the return from owing a given item far exceeds the historical risk from owning that type of item as evidenced by the cost of insuring that item being far less than the return that I earn.

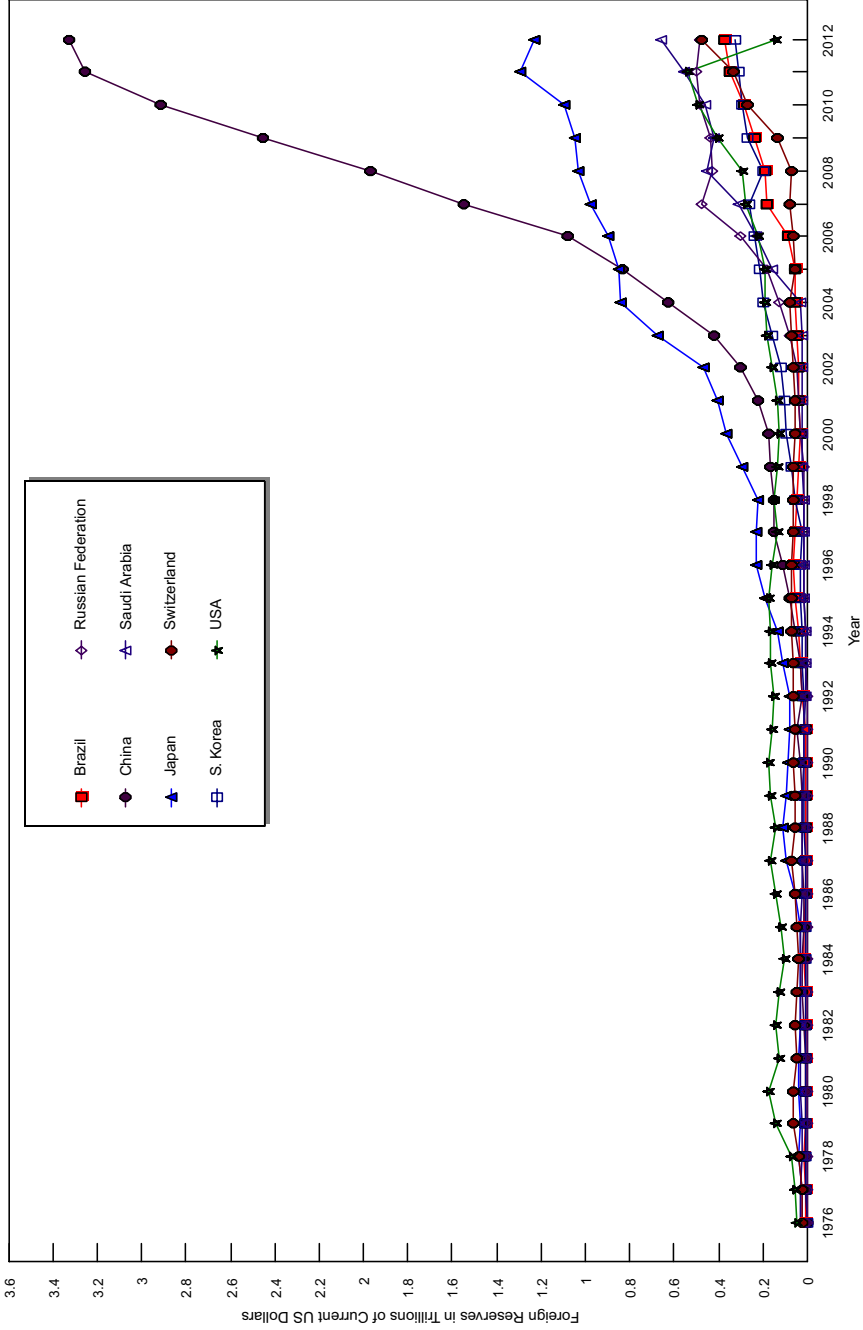


Figure 1.2: Holdings of Foreign Reserves by the Countries with the most in 2011

1 to the selling of mortgage derivatives. Those who bought these derivatives
2 were attempting to earn a return from owning.

3 Most governments welcome long-term capital flows because these
4 flows tend to build factories that increase the host country's productive
5 capabilities and GDP. Many of these same governments are scared of short-
6 term capital flows because these flows tend to focus on getting a return from
7 owning something and can quickly enter or leave a country destabilizing
8 its economy. In a world with insufficient consumption to justify additional
9 productive investment, an increasing percent of total investment is "rent
10 seeking."

11 **Consumption-Driven Growth Worked in the Past**

12 Consider two examples of successful consumption-driven growth: the USA
13 and Japan. Rosenberg (2003) tells how car production and sales in the USA
14 in the 1920s led to investments in industries to make tires, auto parts, plate
15 glass, steel, roads, traffic lights, gas stations, and, ultimately, suburbs. "With
16 suburbanization came increased spending on new housing. Many of the new
17 homes would be electrified and have telephones and radios. Thus, invest-
18 ment spending in electric power, telephone, and communications industries
19 took off" (Rosenberg, 2003, p. 4).

20 The Japanese government, beginning in the late 1950s, purposefully
21 targeted improving Japan's income distribution as a major goal of govern-
22 ment policy. This led to the ratio of the wage bill to profits increasing from
23 0.902 to 3.065 between 1952 and 1981 (Leightner, 1992). The average
24 real personal income for Japan's urban workers and farmers nearly dou-
25 bled between 1955 and 1959 (Ozawa, 1985). These changes led to Japan
26 enjoying several waves of consumption-driven growth.

27 TV sets, which were used in only 16 percent of [Japanese] households in 1958,
28 were used in as many as 91 percent by 1963. The popular consumer durables in
29 the early 1950s were relatively low-income products such as radios, fluorescent
30 lamps, bicycles, electric fans, and sewing machines. The later 1950s saw a growth
31 in demand for monochrome TV sets, washing machines, and automatic rice cook-
32 ers. The demand for more sophisticated high-income goods such as color TVs,
33 refrigerators, air conditioners, and automobiles expanded phenomenally through-
34 out the 1960s, but especially in the latter years of the decade.

35 Consumer demand for clothing similarly underwent a qualitative change: syn-
36 thetic fiber or blended fiber products became increasingly popular as many of

1 them had a permanent press feature. And tastes for fashion-oriented clothing, too,
 2 developed significantly. Many of these consumer goods are time saving in nature
 3 for housewives and created more leisure time. On average, the Japanese housewife
 4 spent 11 hours per day on household chores before the war but less than 8 hours
 5 at the end of the 1960s. Innovations in the consumer goods sector, therefore, in
 6 turn created new demands for leisure-related goods and services (Ozawa, 1985,
 7 pp. 233–234).

8 **Outline of the Rest of the Book**

9 The core of the world’s economic problems today is a surplus of savings.
 10 This savings is not being invested in expanding production because there
 11 is insufficient consumption to justify production expanding investment.
 12 The primary solution to this problem is to increase consumption provid-
 13 ing a reason to invest the surplus savings in production expanding ways.
 14 China is the only major country today that is actively and openly embracing
 15 consumption-driven growth.² In contrast, Europe, as directed by the Inter-
 16 national Monetary Fund (IMF), is attempting to reduce wages and labor
 17 power in order to restart export-driven growth. The European approach is
 18 counter-productive.

19 The rest of the book develops the details of the above thesis as it relates
 20 to the experience of Brazil, China, Japan, the Russian Federation, Thailand,
 21 the United Kingdom, the USA, and the 17 countries that use the Euro.
 22 Chapter 2 examines banking policy. Chapters 3–5 theoretically and empiri-
 23 cally examine the effects of changes in the money supply ($M-1$), government
 24 spending (G), and exports (X) on GDP. The estimates of $\partial \text{GDP} / \partial M-1$,
 25 $\partial \text{GDP} / \partial G$, and $\partial \text{GDP} / \partial X$ in these chapters³ show that the effectiveness
 26 of monetary, fiscal, and trade policies are falling by a noticeable amount

²Japan has also talked about “consumption-driven growth;” however, the Japanese govern-
 ment’s plan to increase the national sales tax in early 2014 is contrary to such a model.

³The notation “ $\partial Y / \partial X$ ” means the “change in Y due to a one unit change in X .” In other
 words, $\partial Y / \partial X$ is the slope of the line (or the derivative of the line) showing the relationship
 between Y and X . In Chapter 7, I use annual data for China from China’s Statistical Yearbook.
 For all other chapters, I use quarterly data from the IMF. I always use the maximum amount
 of data available. I use a statistical technique, explained in Appendix 1, which is designed
 to capture the influence of variables that are not explicitly included in the analysis (omitted
 variables). This technique produces a separate slope estimate for each observation making
 it possible to see how $\partial Y / \partial X$ is changing over time.

1 for most of the countries examined. This result means that the methods
2 currently being employed to solve the crisis are becoming less and less
3 effective. Furthermore, I find that in many cases, the negative effects of
4 cutting the money supply, government spending, and exports exceed the
5 positive effects of increasing these items. This implies that to undo the
6 damage caused by cutting government spending under austerity, Spain, for
7 example, would have to increase government spending much more than
8 they cut it.

9 The empirical estimates in Chapter 6 show that, since 1995, countries
10 have not been able to successfully increase GDP by accumulating additional
11 foreign currency in an effort to depress their exchange rates and increase
12 exports. Chapter 7 presents a detailed analysis of what China has already
13 done, is currently doing, and still needs to do to implement a consumption-
14 driven growth model. Chapter 8 examines the effects of income distribu-
15 tion on growth. Chapter 9 concludes by arguing that the effectiveness of
16 fiscal, monetary, and trade policies would be enhanced by embracing a
17 consumption-driven growth model.