



The Wealth of Modern Nations

By John H. Makin

Top economic policymakers from China and the United States met in Beijing in mid-December 2006 for the first round of what has been called the U.S.-China Strategic Economic Dialogue (SED). There is a lot more at stake than the level of China's currency when the world's premier economic sprinter—China—meets with the world's premier economic long-distance runner—America. The fundamental issue at hand is the creation and preservation of wealth of two nations, each of which has much to teach the other. The right outcome from the dialogue would provide a substantial boost to the global economy in coming years, while the wrong outcome would threaten the continuation of global prosperity.

Wealth Creation and Storage

In his monumental treatise *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith does not directly address wealth creation (the “natural progress of opulence,” as he calls it) until book three, about 350 pages into his lengthy analysis. For Smith, “the natural course of things” is first agriculture, then manufacturing, and finally foreign commerce.

Smith's treatments of wealth creation and of wealth storage—the role of the financial sector—may be inadequate to address fully the growing economic and financial relationship between America and China. Better scholars than I may be able to demonstrate that what I have to say here was, for the more discerning reader, all fully articulated by Smith. If that is so, I only suggest that,

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given the rising risk of acrimony in the economic dialogue between the United States and China, the points being raised here about the synergy between the real and financial sectors of modern economies bear repeating.

Smith's triad of steps on the progress of opulence seems remarkably apt as a characterization of today's star economy—China. That nation is consistently growing at a rate of nearly 10 percent a year as tens of millions of workers are being absorbed into a manufacturing sector that has come to dominate global production of goods. Simultaneously, foreign commerce has drawn capital and market skills into China that have, in turn, further enhanced the growth that the country has achieved with the employment of vast, heretofore underemployed agricultural labor.

China is today's most rapidly growing large economy, exceeding both in pace and scale the rapid growth of Japan's economy during the 1960s and 1970s. And, like Japan, since Chinese growth creates more goods than Chinese households can absorb and more savings than Chinese financial institutions can invest domestically, both its goods and savings flow into the global economy.

The surfeit of Chinese goods at low prices creates benefits for consumers along with trade tensions, as producers in other countries are forced to eliminate, redirect, or relocate production facilities. The surfeit of Chinese savings creates risks of overinvestment and misdirected investment inside China, while fueling demand growth in countries, such as the United States, to which the excess savings flow and encourage dissaving.

The tensions associated with American dissaving are largely associated with what have come to

be known as “unsustainable deficits,” or more mundanely, a persistence of national expenditure in excess of national income. The problem, if there is one for America, is not so much that such “imbalances” are unsustainable, but that they may be eminently sustainable. They can persist as long as China’s financial system is too underdeveloped to manage capital allocation domestically while private capital outflows are largely prohibited by government fiat. These issues are all tied to the “distortions” addressed by Federal Reserve chairman Ben Bernanke during the SED meeting in Beijing.

The wealth of modern nations and its enhancement requires a well-developed financial sector, something not much explored by Adam Smith. China’s emergence as the world’s preeminent producer of goods alongside the United States—which, while still a major goods producer, is the world’s preeminent supplier of financial services—has given rise both to tensions and opportunities, the examination of which provided a full agenda for the Strategic Economic Dialogue.

One can hope for a positive-sum game between America and China. Much is to be gained by understanding “the natural progress of opulence” that emerges from closer ties between the world’s preeminent “real” economy, China, and the world’s preeminent financial economy, the United States.

Crucial Role of the Financial Sector

Fundamentally, successful economies do two things: organize and carry out efficient production of goods and services and, once past subsistence, allocate capital among alternative uses while simultaneously storing wealth. Economic development and attainment of “durable advanced economy” status require the symbiotic, ongoing growth of both the real and financial sectors of the economy. Contrary to populist demagoguery as practiced by Lou Dobbs and others, people “work for a living” in both the real and financial sectors of the economy. Each is necessary for sustained economic growth and wealth enhancement.

Indeed, the most difficult part of the transition to status as a durable advanced economy is the development of a resilient financial sector. The British economy thrived during the century before World War I in no small part

because, after the Industrial Revolution had transformed the operation of the real economy in England, a more advanced financial order emerged. The gold standard and its management by the Bank of England formed the basis for a stable British financial system that operated imperfectly at times, but on balance functioned remarkably well to reallocate capital and to store wealth for well over 150 years.

China’s underdeveloped financial sector has forced the Chinese government to import wealth-storage and management facilities from the United States and Europe. The dominant role of the United States in this activity accounts for the “sustainable” U.S. current account deficit.

Postwar Japan worked, saved, and invested to achieve remarkable success of the “real” economy during the 1970s and 1980s, but failed to develop an efficient financial sector. By the late 1980s, the massive flow of Japanese savings, without the benefit of a modern financial system to allocate capital and to store wealth, drove the real return on capital to zero. The resulting collapse of the stock market in 1990 and of the land market in the several years thereafter, erased Japanese wealth equivalent to about three years of national income. That would be the equivalent of an astounding \$40 trillion for today’s American economy. The Japanese did not allow much capital to flow out of the country and allocated inefficiently the huge stock of funds locked inside. The result was a financial disaster followed by more than a decade of substantial real economic weakness.

Today, China is sustaining both 10 percent economic growth and massive investment, both conventional earmarks of a powerful real economy. But China’s financial sector remains dangerously underdeveloped. Capital allocation is still far too arbitrary, largely directed by poorly staffed state banks with limited experience in identifying viable investments. Political expediency drives too much of China’s capital allocation. Beyond that, the surfeit of private capital is largely trapped inside China as the result of restrictions on capital outflows imposed by China’s nervous communist oligarchs.

The important relief valve for China’s excess savings is the huge flow of capital from China’s government to U.S. and European capital markets. This, however, results from persistent undervaluation of the currency and restrictions on private capital outflows. China’s underdeveloped financial sector has forced the Chinese government to import wealth-storage and management facilities from the United States and Europe. The dominant role of the United

States in this activity accounts for the “sustainable” U.S. current account deficit and, in part, for the extraordinarily low, 4.5 percent, long-term U.S. interest rates in the face of the Fed’s boost of short-term rates from 1 percent to 5.25 percent between June 2004 and June 2006.

Despite China’s decision to store its \$1 trillion-plus foreign-exchange reserves, equal to an extraordinary six months of income, at least two fundamental problems remain. First, China’s domestic investment, exceeding 40 percent of GDP, remains far too large and too poorly allocated among alternative uses to sustain the country’s growth. The result, as Japan discovered after its own decade (the 1980s) of excessive and poorly allocated investment directed by government bureaucrats, will be financial turmoil that weakens the real economy.

Second, China’s undervalued currency is resulting in overinvestment in its traded-goods sector that generates, in turn, politically charged rising trade surpluses. The issue is not so much whether a floating yuan will reduce China’s trade surplus or America’s trade deficit, but whether it will help to balance investment flows between China’s traded and non-traded sectors while diffusing rising trade tensions that could result in protectionist legislation. Such legislation represents yet another avenue of potential damage to the real economy resulting from imbalances within China.

America’s Lessons for China

For close observers, China’s economy serves as a mirror that reflects the factors behind the remarkable success of the American economy over the past twenty-five years. As already noted, China lacks a modern, private financial sector. America possesses the world’s most advanced financial sector, which offers a sometimes bewildering yet attractive array of wealth-storage facilities.

The symbiosis between America’s financial sector and its real economy has been enhanced by a sharp reduction in the level and volatility of inflation, a change engineered after 1980 by the Federal Reserve System under Paul Volcker and sustained by Alan Greenspan. Simultaneously, deregulation has enhanced the ability of the U.S. financial system to become more innovative.

The lower and more stable level of inflation rate going back to the early 1980s has greatly improved the

functioning of America’s economy while providing more opportunities for financial integration. The term “Great Moderation” refers to this phenomenon. It has many features, but most broadly, it describes sharp reductions, after 1983, relative to the previous postwar years since 1947, in the *volatility* of economic growth and inflation. Simultaneously, the *level* of growth was maintained and recessions were sharply curtailed and moderated. In the twenty-four years since 1983, the

U.S. economy has spent only sixteen months in recession, after having spent more than fifty months in recession during the twenty-four years prior to 1983.

China may have wished to peg its currency to the dollar, in effect, to make the Fed, as author of the “Great Moderation” in America, its central bank. In principle, this is a sound idea, but in practice it requires dismantling of controls on private capital outflows and development of a modern financial system in China. These steps will require time for China to complete, but it is very important to initiate movement toward a stronger financial system now if China is to escape

Japan’s post-1980s collapse resulting from too much poorly allocated investment at home. Some further Chinese movement along the path to currency flexibility would also help to buy time and smooth the flow of resources from the production of traded goods into production of goods for China’s domestic consumption.

Lessons for America and China

Adam Smith made clear 230 years ago the important yet now seemingly obvious insight that the primary goal of a market economy, driven by enlightened self-interest, is wealth creation that accrues to workers in the economy. Today, we recognize perhaps a little more clearly that wealth creation emanates from the financial sector as well. Wealth, once created, must be reinvested if it is to continue to support consumption and further capital formation. The success of America’s advanced economy and the growth of its financial system are perhaps best illustrated by the extraordinary growth and preservation of wealth in the more stable environment that has prevailed since the mid-1980s.

During the volatile and inflationary 1970s, American real net worth grew at an average of 2.57 percent

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per year. During the 1990s, the annual growth rate of wealth more than doubled to 5.25 percent per year before being interrupted by the stock market crash in 2000. Such corrections are inevitable in a modern financial system. The important thing is recovery. Growth in American wealth has recovered to a 4 percent rate over the year ending in the third quarter of 2006, the latest period for which we have comprehensive data.

The path to symbiotic development of the American and Chinese economies is clear. America needs to continue to maintain open markets for goods in order to benefit from China's vibrant real economy. China needs to

open its capital markets and allow American investment in its banks in order to benefit from America's vibrant and innovative financial sector.

The path, while clear, will not be an easy one to follow because of vested interests in both countries favoring restrictions on trade and financial flows. But persistence and flexibility by governments, businesses, and financial institutions both in America and China, aimed at integrating the real and financial sectors of the two economies, would do a great deal to enhance the wealth of modern nations.

Adam Smith would be proud, both of America and China.