Misunderstanding Investment in the United States and China

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America and China have very different views of the role of investment in creating economic growth. In America, we believe in shareholder value. Companies should invest in activities that have high rates of return, which will maximize productivity and growth. The job of government is to get out of the way. China believes the opposite. It values national market shares over rates of return. Far from getting out of the way, the government intervenes to provide cheap capital to fund high investment.

Market fundamentalists tell us that the U.S. system is superior and that China's methods are bound to backfire. But force-fed investment has worked well for China. Since 2001, its GDP has grown by 250 percent compared to America's 35 percent.[1] China has also risen from number four to number one in the world (by a large margin) in manufacturing.

Have market fundamentalists misunderstood the drivers of investment and growth? That much is suggested in the new book *Trade Wars Are Class Wars* by business journalist Mathew Klein and finance expert Michael Pettis. Klein and Pettis argue that investment is not limited by the amount of capital available but by national consumption and demand.[2] Supplementing their arguments with earlier work by the recently deceased Harvard Business School professor Clayton Christensen—who argued that financial metrics have caused American corporations to focus too much on cutting wages and offshoring and too little on investment and productivity[3]—makes clear that the sources of investment and growth have been largely misunderstood by many economists and policymakers.

It's the Demand, Stupid

Klein and Pettis's primary concerns are trade surpluses and deficits, and how international trade balances are shaped by income inequality within nations. But for our purposes, the authors' most important argument is that investment is not constrained by the amount of capital available but by "insufficient consumption."[4] Their clearest illustration of this phenomenon is the Hartz reforms in Germany in the early 2000s, which reduced wages and boosted the incomes of owners of capital in an attempt to make Germany more competitive internationally. The expectation was that the resulting higher savings would fuel higher investment and growth, but instead investment fell. Klein and Pettis say this happened because Germany's investment was constrained by domestic demand, which wage cuts reduced.

The authors argue that this demand constraint holds generally in advanced economies today. Investment used to be capital constrained, but starting in the late 1970s, global capital supplies grew rapidly and the world became flooded with cheap capital.

Klein and Pettis make two related arguments about the United States. The first is that America's stagnant wages have limited demand and investment. The authors quote Marriner Eccles's (FDR's Federal Reserve chairman) diagnosis of America's economy before the Great Depression: "By taking purchasing power out of the hands of mass consumers, the savers denied to themselves the kind of effective demand for their products that would justify a reinvestment of their capital accumulations in new plants."[5]

Second, Klein and Pettis argue that the high savings of the wealthy are much less conducive to investment and growth than commonly thought. If investment is limited by the amount of demand in the economy, then any increase in savings that results from giving more income to the wealthy is unlikely to go into investments in the real economy. Instead, it mostly goes toward bidding up financial asset prices or increasing consumer debt. As Pettis put it in an earlier blog post, "Today, because it is weak demand, not high costs of capital, that restrains business investment, income inequality does not lead to higher investment. On the contrary, it leads to slower growth, more debt, and perhaps even less investment."[6]

The Perils of RONA

Clay Christensen agrees that the world is awash in capital, but his analysis goes down a different path. He is concerned with how companies invest. Christensen criticizes the "seminarians of new finance" who insist that investment decisions must be based on financial metrics like internal rates of return (IRR) and return on net assets (RONA). He links these ills to the excesses of the shareholder value movement, which holds that companies should be run primarily, if not exclusively, to maximize shareholder returns. As Christensen points out, 95 percent of stock market transactions are driven by hedge funds and other institutional managers who hold stocks for less than a year.[7] These funds are not owners but renters; they are not investors but speculators. When they force CEOs to focus on maximizing quarterly returns, long-term value creation suffers.

Christensen identifies a contradiction at the core of modern finance: In economic terms, the world is awash in capital and interest rates are historically low, which should lead to the higher use of a resource that has become cheaper. But shareholder value metrics treat capital as *the most scarce resource* whose use can only be justified by investments with very high rates of return. This has led American companies to impose high hurdle rates on new investments—often 15 percent or more, which means that investments have to pay for themselves in five years. This discourages investment in general and disruptive innovation in particular.

Renowned as a theorist of business innovation, Chistensen distinguishes between "efficiency" or "sustaining" innovations (incremental improvements that lower costs but do not create new markets or jobs) and "disruptive" innovations (which create new products or services that generate new customers and create jobs). Disruptive innovations are particularly important because they drive the positive side of Schumpeterian creative destruction. But they are hard to achieve. Efficiency innovations are much easier to accomplish, but do not drive strong job creation or growth. Sustaining innovations can often pass hurdle rate tests because they pay back quickly, but disruptive innovations often cannot because the time horizons required are too long.

Metrics like RONA are even more perverse. Because they are ratios of earnings to assets, CEOs can improve the ratios either by investing more in order to increase returns (but that puts more assets on the balance sheet) or by cutting jobs, lowering wages, reducing capital equipment, or offshoring (which aim to increase profits without increasing assets or to reduce assets without reducing profits). Companies typically find it easier to maximize RONA by downsizing, cutting wages, or offshoring than by investing for the future.

Offshoring has had high costs for U.S. manufacturing and jobs. Christensen tells the story of Dell's interactions with AsusTek in Taiwan. Dell starting by offshoring simple circuit boards to AsusTek, but then moved on to assembly, other components of the supply chain, and finally product design. At each stage, Dell increased its profits and reduced its assets, but the eventual outcome was that Dell had the brand and AsusTek had the jobs.[8]

Thus RONA and corporate short-termism produce what Christensen called the capitalist's dilemma:

> Doing the right thing for long-term prosperity is the wrong thing for most investors, according to the tools used to guide investments. In our attempts to maximize returns to capital, we reduce returns to capital. Capitalists seem uninterested in capitalism—in supporting the development of market-creating innovations.[9]

Challenges to Market Fundamentalism

Taken together, the Klein-Pettis and Christensen arguments are mutually reinforcing and help explain many of the adverse trends that have characterized the U.S. economy in recent decades. First, they help explain the U.S. manufacturing slowdown. Klein and Pettis outline the macro issues arising from Chinese policy and offshoring, while Christensen explains corporate unwillingness to make large capital investments and the metric-driven desire to reduce physical assets.

Second, both help explain why U.S. wages have grown slowly and declined for workers with less education. Offshoring has broken the partnership between American capital and labor; RONA has pushed U.S. companies to pursue offshoring with a vengeance; and high hurdle rates have limited disruptive innovations that create high-paying jobs.

Third, they help explain low U.S. investment. If the bottom 50 percent of the population, which spends most of what it earns, has stagnant incomes, and the top 10 percent (and especially the top 1 and 0.1 percent) gets a lot of income but spends less, national demand and, therefore, investment are held back. Keynes and Eccles would agree. With their high hurdle rates, U.S. companies limit investment even more.

Fourth, they help explain slowing productivity gains. If investment is low, productivity advances will be limited. If companies are reluctant to invest in disruptive innovations, the United States will not experience big productivity jumps.

When market fundamentalists began their takeover of U.S. policies and corporate practices in the 1980s, they promised that financial deregulation, tax cuts for the wealthy, and the shareholder value movement would produce increased investment, faster productivity gains, and rising wages. Although none of these things has happened, the paradigm has proven remarkably durable. The main reason has been that powerful elites have benefited from it. But the paradigm also relies upon an economic narrative that many have found persuasive: The source of growth is private enterprise and finance. If the government just gets out of the way, the private sector will create prosperity and jobs. A strong financial sector provides the capital that companies need to invest and grow. Shareholder pressures ensure that companies use capital wisely. Inequality is a price we have to pay for strong private investment and growth.

Critics have attacked market fundamentalism on moral and political grounds but have not deconstructed this economic narrative. This is why the arguments of Klein and Pettis as well as Christensen are so important.

Klein and Pettis pose the most basic challenge: If market fundamentalist policies produce stagnant wages and a skewing of income to the top, low demand will limit investment and growth, and the higher savings of the wealthy will not help. The market fundamentalist paradigm gets inequality wrong. Far from being a spur to growth, high inequality is an obstacle to it.

Christensen illustrates the reasons for this failure at the level of individual firms: The shareholder value movement has backfired. It has led to high hurdle rates that force individual investments to look profitable, but that systemically reduce total investment and disruptive innovations.

These are major indictments, but they don't exhaust the case against market fundamentalism. Two other shortcomings can be briefly noted. First, finance does not support real investment the way its advocates claim. On the contrary, the financial sector's high profits have coincided with low investment in the real economy. One reason has been that high financial profits raise the opportunity costs of real investments—if a company can generate high returns from financial engineering, why should it accept lower returns from real engineering? It is also not true that most U.S. companies rely on the financial sector for capital. Most companies finance investment out of retained earnings, but many, at the behest of financial market activists and advisers, have been returning increasing amounts of capital to shareholders via stock buybacks.

Second, it is not just private investment that has been hurt by market fundamentalism, but public investment as well. When taxes are cut and entitlements spiral upward, the casualty is public investment in R&D, infrastructure, and education. Globalization and the rise of China would have hurt U.S. manufacturing and put downward pressures on American wages no matter what U.S. policies were in place, but market fundamentalist practices have made these problems worse.

China's High Investment

Let us now turn to China. Klein and Pettis provide a sophisticated assessment of China's growth methods, invoking the economic theories of Alexander Gershenkron and the growth strategies pioneered by Japan and the Asian Tigers. Gershenkron argued that poor countries do not have enough savings to fund investment or the business skills needed to build modern productive capacity. To break out of this dilemma, the state should boost saving by holding consumption down and lead investment in infrastructure and manufacturing.[10] Meiji Japan and the Asian Tigers followed this model, but added their own emphases on export promotion.

China has followed in the footsteps of its East Asian predecessors (especially Taiwan), but with two differences. First, it has relied much more heavily on state direction. According to Klein and Pettis, the Chinese government sets the level of investment. The government decides how fast it wants the economy to grow in a given year, calculates how much investment is needed to meet that target, and directs the state-owned banks to push out the needed amount of capital.

Second, China has put the East Asian model of high saving and investment on steroids. Whereas most East Asian nations peaked at 30–35 percent of GDP in savings and around 30 percent in investment, China has saved an incredible 45–50 percent of GDP and invested 40–45 percent. No major nation has ever invested this much.

The Klein-Pettis analysis of China has some limitations, however. The most significant is that the authors' focus on the costs of suppressed consumption lead them to overstate the costs of high investment: "Funding investment at the expense of consumption is therefore self-defeating if the result is excess capacity and impoverished workers—precisely the situation in China since the early 2000s."[11]

This is an incomplete picture. China's high-investment methods can actually be viewed as an answer to the dilemma of low wages and low demand that Klein and Pettis highlight. As the authors point out, China has severely suppressed wages from the beginning and today has the lowest share of GDP in consumption of any major nation. By the authors' theory, this could have held down domestic demand and investment (as happened in Germany).

But that did not happen. The main reason is that China does not let market forces set its level of investment. As noted above, the government sets that level artificially high to force-feed industrial expansion and growth. It also makes capital artificially cheap. It does this by paying savers negative real interest rates (lower than inflation) and passing the low rates on to companies. As Pettis has said:

> China's growth is actually heavily capital intensive. . . . Large Chinese businesses behave . . . not as if labor is the cheapest input they have but rather as if capital were the cheapest input. They are right. Labor may be cheap, but capital is almost free.[12]

According to Western economic theories, such manipulation of investment is not supposed to work. Overinvesting and underpricing capital should lead to malinvestment, bad debts, and falling productivity. China has had these problems to a degree (especially since 2010), but in strategic terms, high investment has been a major driver of China's rapid growth.

Skill and Luck

China's investment methods should also be viewed within the context of its broader growth strategy. That strategy is based on China becoming and remaining the most cost-effective producer of manufactured goods (starting low and moving upmarket) and on the acceptance of low profits and even losses in order to expand market shares.

This strategy involves "two blades of the scissors." The first blade is low costs. China has kept costs low by holding wages down, accepting low or negative profits, enduring severe environmental damage, and so on. Combined with its natural cost advantages, this blade has allowed China to underprice everyone else.

The second blade is strong manufacturing capabilities. China has strengthened its capabilities by subsidizing company investments and by making massive public investments in infrastructure. Most Chinese companies don't use hurdle rates. They respond to the incentives offered by local governments, whose officials are judged by their success in expanding factories and jobs. If the companies are in sectors that the Communist Party considers critical, they will receive massive subsidies.

This is the Gershenkron strategy on steroids. The government leads investment and provides large subsidies for manufacturing because manufacturing allows steady productivity gains and benefits from expansions of scale and scope (scale through the sheer magnitude of the manufacturing surge and scope through the development of extensive industrial clusters).

When you put extremely low costs together with extremely high investment, you get a world-beating "China price" that allows China to dominate global manufacturing. China has also benefited from unusually favorable conditions, especially from 2001 to 2008. The one-child policy gave it good dependency ratios; the massive shift of workers from farms to factories drove rapid gains in productivity; and Western companies boosted China's technology and high-end exports. Some of those conditions have moderated since 2009, but China has continued to make rapid gains in manufacturing and GDP.

The China Model's Hidden Costs

The public myth (promoted by China) is that China's rapid growth has been a boon to the world—it has reduced global poverty, helped other emerging market nations advance, and provided cheap goods to Western consumers. Some of this is true, but some of it is misleading. Most of China's contributions to poverty reduction have been within its own borders. Many other emerging market nations have grown faster and reduced poverty, but most have done so by exporting raw materials and commodities, which has left them vulnerable to the vicissitudes of commodity-led growth.

The impacts on Western nations (especially the United States) have been more adverse. Yes, cheap goods have helped consumers, but China's undervalued currency, industrial subsidies, and wage suppression have hit Western workers hard. The problems of China's high trade surpluses and excessive subsidies are well known, but the negative impacts of China's wage suppression have not been well understood.

Klein and Pettis explain how this works. When China keeps its wages artificially low, its hypercompetitive exports force other nations to adjust. In Germany, the government lowered wages to try to remain competitive. In other cases, the mechanisms were different but the impacts similar. The result has been a self-reinforcing cycle of cost-cutting, which has hurt global demand and growth:

> The perverse result is that deepening globalization and rising inequality have reinforced each other. Businesses across the world use international competition as an excuse to push for lower wages. . . . Squeezing ordinary

> households has, apparently, been much easier than increasing productivity. . . . This is unsustainable, however, because depressing wages must lead to some combination of lower consumption, which reduces total spending in the global economy, and higher indebtedness, which is ultimately self-limiting and self-defeating.[13]

The United States has been hit particularly hard due to our market fundamentalist policies. Here, workers are more exposed to global forces than in other nations, and U.S. companies have made wage pressures worse by their obeisance to RONA.

America's Potential

The last twenty years have been a golden age for China and two lost decades for the United States. China has enjoyed a virtuous circle of rising investment, fast-growing manufacturing, and rapid growth. Even though consumption is a low share of GDP, incomes have risen rapidly.

America, by contrast, has suffered from a vicious circle of low investment, slow productivity gains, manufacturing job losses, and slow growth. And because most of the gains from relatively low U.S. growth have gone to the top, wages have stagnated.

The past is not necessarily prologue, however. Longer-term growth trends could be more favorable to the United States. China's overinvestment means that it has little untapped upside potential. In addition, it faces serious downside forces, especially severe aging and high corporate debt. China's growth will slow; the question is how much.

America, on the other hand, has major upside potential because we have been leaving so many growth opportunities on the table. When you have been pursuing policies that make inequality and investment worse, you can make big gains by changing those policies. A central message of both Klein-Pettis and Christensen is that better equality and higher investment are complements. New policies that prioritize public and private investment and raise wages through productivity improvements would be win-win.

Unfortunately, such changes will be strongly opposed by American corporate and financial elites. It is not just trade policy that is subject to class wars, but all economic policy.

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Notes

The views expressed in this paper are those of the author and are not an official policy or position of the National Defense University, the Department of Defense, or the U.S. government.

[1] GDP in constant prices calculated from Federal Reserve Bank of St. Louis data. Last data are for 2017.

[2] Mathew C. Klein and Michael Pettis, *Trade Wars Are Class Wars: How Rising Inequality Distorts the Global Economy and Threatens International Peace* (New Haven: Yale University Press, 2020).

[3] Clayton M. Christensen and Derek C. M. van Bever, "The Capitalist's Dilemma," *Harvard Business Review* (June 2014): 60–68. See also: Clayton Christensen, "Disruptive Innovation" (lecture, Said Business School, University of Oxford, June 9, 2013), YouTube, June 19, 2013.

[4] Klein and Pettis, 76.

[5] Klein and Pettis, 81.

[6] Michael Pettis, "Wealth Should Trickle Up, Not Down," Carnegie Endowment for International Peace, June 19, 2019.

[8] Christensen, "Disruptive Innovation."

[9] Christensen and van Bever, 66.

[10] Klein and Pettis, 106–7.

[11] Klein and Pettis, 102.

[12] Michael Pettis, "China's Troubled Transition to a More Balanced Growth Model," New America, March 1, 2011.

[13] Klein and Pettis, 224–25.