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Trade Wars Are Class Wars: How Rising Inequality Distorts the Global Economy and Threatens International Peace

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Yet there is no economic conflict between America and China as countries. The Chinese people are not the enemy. Rather, there is a conflict between economic classes within China that has spilled over into the United States. Systematic transfers of wealth from Chinese workers to Chinese elites distort the Chinese economy by strangling purchasing power and subsidizing production at the expense of consumption. That, in turn, distorts the global economy by creating gluts of manufactured goods and by bidding up the prices of stocks, bonds, and real estate. Chinese underconsumption destroys jobs elsewhere, while inflated asset values lead to devastating cycles of booms, busts, and debt crises. China's policies do not just hurt Americans—they also harm ordinary Chinese workers and retirees. Chinese workers are underpaid relative to the value of what they produce, and they are taxed too much. They are unable to access the goods and services they ought to be able to afford. They breathe dirty air and drink polluted water because many local government officials place the financial interests of politically connected business owners above the well-being of the public.

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. Tariffs and nationalist rhetoric will not resolve China's imbalances, but they will likely reinforce the mistaken belief—on both sides—that China and the United States have incompatible economic interests. Mishandling legitimate grievances could threaten international peace without even addressing the underlying problems. Class wars are already causing trade wars, as they have in the past. It would be a tragedy if they led to something worse. At the same time, doing nothing is not an option. China is too large an economy for the rest of the world to passively accept the consequences of its internal distortions. It may seem strange to think of China's domestic economic policies as a legitimate subject for international diplomacy, but it is a necessary implication of the global connections that link humanity together. Convincing Chinese elites to allow Chinese workers to consume a greater share of what they produce is one of the great policy challenges of our time. Reversing the transfers from regular people to the rich over the past thirty years is in the interests of both the Chinese people and the American people. The situation in Europe is far less likely

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This was recognized by astute observers at the time. According to the British economist and social critic John A. Hobson, the need to find outlets for “surplus capital which cannot find sound investments within the country” was the central explanation for American and European imperialism. The underlying problem was an economic and political system that “placed large surplus savings in the hands of a plutocracy.” Income concentration gave the rich “an excess of consuming power which they cannot use” at the expense of everyone else. This was ultimately self-defeating, since “consumption alone vitalizes capital and makes it capable of yielding profits.” Rich savers therefore had to search abroad to find “new areas for profitable investment and speculation.” Eventually, this search encouraged powerful domestic interests to “place larger and larger portions of their economic resources outside the area of their present political domain, and then stimulate a policy of political expansion so as to take in the new areas.” The good news was that the toxic combination of inequality and imperialism could be peacefully resolved by changing the income distribution. “The home markets,” Hobson wrote, “are capable of indefinite expansion” as long as “the ‘income,’ or power to demand commodities, is properly distributed” among the people. “There is no necessity to open up new foreign markets,” Hobson wrote, because “whatever is produced in England can be consumed in England.”⁷ Hobson made that argument in 1902.

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Even then, most trade at the time consisted of finished goods and commodities. The innovation of container shipping radically lowered transportation costs while advances in communications technology made it easier to oversee factories on the other side of the world. By the late 1990s, trade had been transformed. Companies spread complex manufacturing supply chains across multiple countries to maximize efficiency and minimize taxes. Trade today looks nothing like it did before. Unfortunately, in spite of all these changes, the popular understanding of trade continues to be based on obsolete eighteenth-century models.

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Ricardo’s subtle case for free trade depended on persistent differences in rates of return across countries, which in turn depended on investors’ unwillingness to move money abroad. Those assumptions broke down as technology improved, communication costs collapsed, and global politics changed.

On the other side of the Atlantic, a dozen years or so after Smith published *Wealth of Nations* and nearly thirty years before Ricardo published his *Principles*, George Washington and Alexander Hamilton presented a different vision of economic statecraft. For them, the development of domestic manufacturing capacity was a national security imperative. America was isolated diplomatically and geographically, vulnerable to naval embargoes, and far from any potential allies. The United States, they decided, would have to become economically self-sufficient to guarantee its newfound political independence. As Washington put it in an address to Congress on January 8, 1790, “A free people ought not only to be armed, but disciplined.... Their safety and interest require that they should promote such manufactures as tend to render them independent of others for essential, particularly military supplies.” To use the language of Ricardo, Americans would have to make both cloth and wine, regardless of what any economic theory might suggest.⁸ Washington established the need to industrialize. Alexander Hamilton, the first Treasury secretary of the United States and a leading advocate of a powerful federal government, was given the job of figuring out how to do it. His magisterial *Report on the Subject of Manufactures*, published at the end of 1791, would prove to be a founding document of the developmental state. Hamilton believed that manufacturing had value far beyond its contribution to national security: it would “diversify the industrious pursuits” of the citizenry, raise agricultural productivity, and encourage investment in machines. Moreover, he realized that America’s status as an agrarian republic was a consequence of British imperial policy, not destiny. Under the right conditions, the new United States could transform itself into a manufacturing superpower—but those conditions needed to be created by a strong state to encourage the market to create the right sort of manufacturing capacity. Hamilton’s insight was that countries could only capture the productivity gains from the division of labor by rejecting the concept at the international level. The benefits of internal economic diversity were incompatible with national specialization. It was a rebuttal to Ricardo before the theory of comparative advantage had even been written. Hamilton admitted that Americans might want to focus on farming in a world with perfect free trade and zero regulations. He was quick to point out, however, that in the real world, “the United States cannot exchange with Europe on equal terms.” American exports were discriminated against even though the United States levied few tariffs on imports. The difference in treatment stemmed from the fact that Europeans did not depend on American farm output the way that Americans depended on European manufactures. The “want of reciprocity” would keep Americans in “a state of impoverishment.” Activist government was therefore required. According

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The goal was to promote entrepreneurship and investment. Hamilton believed that the guaranteed domestic market would make it easier for Americans to start new businesses in what were then the high-tech industries of textiles, nails, glassmaking, and gun-making. Americans needed “the incitement and patronage of government,” according to Hamilton, because they did not yet have the skills, the credibility, or the confidence to start self-sufficient businesses. The new and unfamiliar are always difficult—a situation made worse by the existing European tariffs and subsidies to encourage their own manufacturers and to prevent the development of manufacturing in the United States. Eventually, America’s “infant” producers would grow and mature to the point that they would not need as much government support. Hamilton did not want to eliminate foreign competition, because that would be bad for American consumers, but he did want to tilt the playing field in favor of additional domestic production

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Ironically, America’s position of neutrality in the decades-long wars between revolutionary France and counterrevolutionary Britain ended up imposing far higher barriers on U.S. imports than anything Hamilton had ever proposed. An indigenous manufacturing industry developed in response. By 1815, President James Madison was calling for more extreme versions of the policies Hamilton had suggested to preserve this new manufacturing base after peace had been restored in Europe. The so-called Dallas Tariff, named after the Treasury secretary at the time, was passed in 1816. It raised duties on many manufactured imports as high as 30 percent and imposed additional taxes on imports brought in on foreign ships.¹⁰ The

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The United Kingdom had a solution, however: its extensive portfolio of overseas colonies. In addition to the so-called white dominions of Australia, Canada, and New Zealand, Britain had control over parts of southern Africa, all of the Indian subcontinent, Hong Kong, Malaya, and bits of the Western Hemisphere. In the last decades of the nineteenth century, the British Empire would dramatically expand to include much of Africa, the Middle East, and substantial spheres of influence in Asia. These territories would not be allowed to develop using List's "National System." Tariffs would be minimal, at least for British goods. The empire would serve as a sink for British exports and provide it with a secure supply of raw material imports. Britain's apparent success with this strategy (scholars disagree whether the military costs justified any of the purported economic benefits) encouraged imitators. The French moved into North Africa and Southeast Asia. Japan seized the Ryukyu Islands. The Russians aggressively expanded their land borders south and west, which frightened the British into additional conquests—Afghanistan, Burma, much of East Africa, and most of southern Africa—ostensibly meant to secure the defense of India. Britain would also fight in Central Asia, Persia, and Tibet because of its fear of losing India. The scramble for Africa became so intense that an international conference (known as the West Africa Conference) was held in Berlin in 1884–85 to prevent military clashes between the European powers.

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By the eve of World War I, all of Africa except for Ethiopia and Liberia had been brought under European control. Japan fought China to take Taiwan and to establish dominance in Korea in the mid-1890s. Ten years later, Russia and Japan fought the world's first war between mechanized armies over control of Korea and Manchuria. While this period of high imperialism was not motivated solely by economic considerations, the desire to acquire export markets and investment opportunities was an important consideration. One consequence was increasing fragmentation of global trade within imperial blocs. Although it annexed the kingdom of Hawaii and took Cuba, the Philippines, and Puerto Rico from the Spanish in 1898, the United States was less focused on acquiring colonial dependencies than the Europeans and more interested in encouraging internal migration to the West, often by violently displacing the indigenous population. America's imperialist tendencies were focused on expanding its own national borders—and its protected domestic market—through the project of Manifest Destiny. This created a distinct American approach to trade with other countries in the late nineteenth century: the Open Door Policy.

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furthering global trade.¹⁸ Despite these moves toward liberalization, the end of the war failed to restore trade to its pre-1929, much less pre-1913, importance. In fact, cross-border flows of goods and services relative to global output would not return to the zenith reached in the 1870s until the 1970s. While Western Europeans began integrating their economies to an unprecedented degree and Japan, bereft of its empire, embraced commercial relations with the West, these developments were outweighed by what was happening in the rest of the world. Half of Europe had been overrun by communists, as would China shortly thereafter. Decolonization led to new trade barriers across much of the world as the liberated countries attempted to industrialize, as the United States had, through import substitution. The international political environment would limit further growth in trade until the end of the Cold War.

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The exact mechanics are complicated and have likely evolved over time, but the simplified version goes something like this. First, Apple's Irish subsidiary pays a fee to the parent in Cupertino, California, to cover the cost of research and development. This counts as an export of services from the United States to Ireland. (Most of America's exports of R&D services go to corporate tax havens, while most of Ireland's imports of R&D services come from the United States.) The next bit is tricky. According to an investigation published by the New York Times at the end of 2016, Foxconn's assembly plant in Zhengzhou, China—which put together about half of all iPhones—is technically not in China at all but in a special no-man's-land surrounded by a customs boundary called a “bonded zone.” This lets Foxconn import components without paying Chinese tariffs. Even more important, the bonded zone lets Apple buy the finished phones from Foxconn before they have technically entered China, sell those phones to subsidiaries based in corporate tax havens such as Ireland, and then let those subsidiaries sell the iPhones to the rest of the world after adding its hefty profit margin.³⁰ This allows Apple to book the bulk of its profits in countries where it pays the least tax even though the phones are shipped from Chinese ports. The result of all this is that Apple paid only about 18 percent of its pretax income in cash taxes in its 2017 fiscal year, although the company expected eventually to pay a tax rate of about 25 percent. (The 2018 data are not representative because of one-time provisions of the new tax law.)³¹ Apple is far from unique. Microsoft, for example, reports that its average effective tax rate in fiscal years 2015–17 was also about 18 percent. Part of the reason is that Microsoft managed to attribute only 12 percent of its total profits to sales in the United States, on average, during those three years. As the company itself notes, “Foreign earnings taxed at lower rates” shaved off about 19 percentage points from Microsoft's U.S. corporate tax rate. Google also paid an average effective rate of around 18 percent. Only some of this can be explained by the lower level of corporate tax rates in America's major trade partners. At least as important is the ability of these companies to report their profits in countries with effective tax rates close to zero.³²

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Software companies are not the only ones able to exploit the weaknesses of the global tax system. Pharmaceutical companies spend billions of dollars to research and develop new drugs. Once the drugs are approved, the cost of manufacturing them is often trivially low. The value comes from the labs that generate the patents rather than the plants where pills are made. Placing the patents offshore and manufacturing the effective ingredients in favorable tax jurisdictions can lower effective tax burdens. Johnson & Johnson, for example, paid an average effective tax rate of about 17 percent in the years before the 2017 tax law changes. “International operations” consistently shaved about 17 percentage points off the headline rate.³³ Almost

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The counterpart to the hyperprofitability of American and European companies’ foreign operations lies in the southwestern bit of the Republic of Ireland, which, officially, is one of the wealthiest parts of Europe. Cork is the largest city in the region and has been home to Apple’s European headquarters since 1980. About six thousand people currently work there in functions ranging from logistics to manufacturing custom iMacs. Major pharmaceutical companies, including Pfizer, GlaxoSmithKline, and Johnson & Johnson, also have operations in Cork. Further north, Dublin is home to subsidiaries of Facebook, Google, and Microsoft.³⁶

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The passage of the 2017 U.S. corporate income tax changes meant that American companies could return as much of these offshore savings to shareholders through dividends and stock buybacks as they wished. So far, the impact has been relatively modest: American companies withdrew just \$250 billion from their foreign subsidiaries in 2018. But the impact has been much larger in the corporate tax havens. There, withdrawals were worth \$319 billion in 2018. The corollary was a \$256 billion decline in the value of U.S. bonds held by residents of the major corporate tax havens between November 2017 and June 2018.⁴⁰ Standard trade data are filled with misinformation for the untrained analyst. The importance of international tax avoidance means that standard bilateral figures are deeply misleading. Fortunately, there is an alternative: the current account combines trade flows with asset income flows and cross-border remittances, effectively canceling out the impact of corporate tax avoidance in the data. It may have once made sense to study trade independently, but it is no longer possible to understand the world economy without a comprehensive understanding of how money moves across borders. That, in turn, requires knowledge of how the international financial system has evolved into its current form. Whereas for much of modern history international capital flows consisted mostly of trade finance, and so mainly reflected trade imbalances, this is no longer the case. Financial imbalances now determine trade imbalances.

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Trade moves goods across space. This takes time and involves risk. Sellers might ship dud goods, pirates might steal the cargo, or bad weather might destroy the shipment. Buyers might back out of paying what they had agreed, or they might have made promises to sell imported goods they cannot keep if the products arrive late. Mere willingness to exchange is therefore insufficient to make trade happen. Finance, which moves purchasing power across space and time, is necessary. Trade and finance have been linked for thousands of years. There are broadly three very different ways in which to think about this relation, however. Each mental model contains radically different assumptions about the sources and consequences of trade imbalances. First, international flows can consist mostly of trade finance. In other words, the financial transactions are driven by relative production and transportation costs. Moreover, because the spread of international trade will be driven by Ricardian principles of comparative advantage, trade imbalances cannot become particularly large or persist for many years. In fact, they will be self-correcting because sustained deficits or surpluses will force domestic adjustments that eliminate the imbalances. Although there may be problems with the distribution of the benefits, the overall global economy unambiguously benefits from this type of trade. Second, international financial flows can consist primarily of rational investment seeking out the most productive opportunities around the world. In this scenario, finance is likely to flow from rich, mature economies to rapidly growing developing economies, so trade imbalances are likely to consist of trade surpluses for the former and trade deficits for the latter. This roughly describes trade for much of the nineteenth century. Again, although there may be problems with the distribution of the benefits, the overall global economy unambiguously benefits from this type of trade and investment because it helps less productive economies to converge with societies at the technological frontier. Alternatively, international financial flows can be driven by a wide variety of factors, including rational investment, speculation, capital flight, fads, panics, mercantilism, the desire for safety, and so on. If trade imbalances are caused by this combination of financial flows, however, any connection between rising trade and broader prosperity is only accidental. There is no longer any clear reason why the global economy would benefit. More precisely, to the extent that financial flows are driven by anything other than rational investors seeking out the most profitable opportunities, trade imbalances probably detract from global growth and distort the composition of many societies. The third mental model is the one that bears the closest relation to reality. None of the main financial technologies—equity, debt, and insurance—are new. The massive scale of international finance, however, is a relatively recent phenomenon. As recently as 1855, the total value of cross-border financial claims was just 16 percent of one year of global economic output. By 1870, however, that figure had jumped to 94 percent. Today, it is over 400 percent.¹ This growth occurred in cycles of booms and busts. Every international lending boom seems to be preceded and accompanied by the same economic phenomena. First, some structural change significantly expands the definition and amount of money, leading to a rapid credit expansion. In England, for example, regulatory changes led to aggressive bursts of bank creation in 1826–37, when the number of banks grew from 3 to 113, and in 1857–73, when the number of banks grew from 98 to 128. Both periods were characterized by major lending booms to developing countries as well as bubbles in the high-tech ventures and other risky projects of the time. Second, an asset boom in the domestic markets encourages increasingly risky behavior by successful investors, usually by borrowing more to make larger bets. As those bets pay off, investors make larger profits that they will want to continue investing in the markets. Finally, some event sets off the fashion for foreign securities, which causes money to pour across national borders, often into risky developing countries.²

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In each case, within a relatively short time, there is a huge expansion of lending and foreign investment to parts of the world that had previously been excluded from it. The recipients of this new credit usually have little in common besides being remote from international financial centers. The boom typically ends when the sudden expansion of lending ends even more suddenly.

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To put it differently, trade flows were determined by financial flows. The financial innovations that led to massive British capital outflows to Latin America in the early 1820s, for example, were directly connected to Britain's massive trade surpluses with Latin America during the same period. These trade relations cannot be explained by analyses of British manufacturing efficiency or the comparative advantages of Latin American producers. The better explanation is that financial flows across borders transformed economies and pushed them to adjust how much they imported and exported.

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At the same time, changes in the discounting procedure of the Bank of England and a significant expansion of its branches vastly increased the quantity of paper credits in circulation. The rapid creation of money was accompanied by an increase in asset and commodity prices, including the price of cotton.¹³ The United States, meanwhile, was living through an economic boom of its own that had been amplified by loosened financial conditions. Before President Andrew Jackson was elected in 1828, the Second Bank of the United States had maintained monetary discipline by regularly buying banknotes issued by other banks and redeeming those notes for gold. This effectively limited how much money the smaller banks could print by tying their note issuance to the fixed supply of metal.

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After Jackson took office, however, he began shifting the federal government's deposits from the Second Bank to politically connected "pet" banks. Flush with new deposits, those banks grew rapidly. The effect was compounded by the Second Bank's loss of deposits, which forced it to cut back on its purchases of other banks' notes. The combined result was rapid expansion of the overall banking system. The number of state banks had already grown from 329 in 1829 (\$110 million of capital) to 506 in 1834 and 788 by 1837 (over \$500 million of capital).¹⁴ At the same time, the federal government had been selling huge amounts of public land and depositing the proceeds in the pet banks. This encouraged speculative purchases of public land with borrowed money, which further loosened financial conditions by effectively converting unimproved land into mortgages. Credit creation drove up asset prices in both Britain and the United States. Rising collateral values boosted bank profitability and encouraged the creation of even more banks. British investors responded to reports of feverish economic activity and skyrocketing markets by embracing the U.S. growth story, pouring huge sums of money into American loans and investments. Recipients included several U.S. state governments, which were considered, in those pre-Civil War times, to be quasi-sovereign borrowers. Money also poured into railroads and canals. Industrial activity drove up the prices of cotton and other commodities used as inputs for manufacturing.

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British investors had never lent to the U.S. federal government, which had paid off the entire public debt in 1835. Instead, the loans went to a variety of private borrowers and to several state governments. The states were the most burdened, particularly since tax revenue was generally low and most revenues consisted of land sales—now sharply reduced because of the specie circular—and various forms of import revenues, now on a collapsing import base. When these borrowers were simultaneously faced with lower import earnings, slowing economic activity, and a standstill in refinancing, they were wholly unable to raise enough gold to make the required payments. The result was predictable. By 1842, at the bottom of the depression, Pennsylvania, one of the richest states and heaviest borrowers, suspended interest payments. By then, Arkansas, Florida, Illinois, Indiana, Maryland, Michigan, and Mississippi had already defaulted along with much of the U.S. banking system. Pennsylvania eventually resumed interest and principal payments, but Mississippi, Arkansas, and Florida, with "carefully rationalized arguments," simply repudiated the debt outright.¹⁸ The international loan crisis was not exclusively an American crisis, but given its huge wealth, promise, and the amounts lent, it was perceived primarily as a U.S. crisis. States, just by themselves and excluding private borrowers, defaulted or rescheduled \$120 million of loans.¹⁹ Europeans were outraged. By the end of the decade James Mayer de Rothschild, the head of the French branch of the House of Rothschild, was reported to have told a visiting representative of the U.S. Treasury, with characteristic pomposity, that "you may tell your government that you have seen the man who is the head of the finances of Europe, and that he has told you that you cannot borrow a dollar, not a dollar." The fury and sense of betrayal of English investors led to an outpouring of hatred and scorn for the American rascals, and English literature is the richer for the many scathing diatribes that followed.²⁰ The

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While most countries have relied on some combination of the two development strategies to pay for their industrialization, each approach has distinct implications for domestic politics and for international trade. High savings lead to trade surpluses because they raise production relative to domestic demand, while high wages tend to produce trade deficits because they raise domestic demand above existing productive capacity in an effort to attract foreign investment. The high-savings model forces ordinary people to spend less so that the government and businesses can spend more. This in itself is not novel: elites the world over have repressed peasants and appropriated their agricultural surpluses for thousands of years. The innovation of the high-savings development strategy is that consumption is squeezed to pay for productive investment in infrastructure and capital goods, rather than to pay for elaborate monuments and the military. Done correctly, this investment raises ordinary people's living standards even as their share of economic output declines. The high-savings model is therefore the original version of trickle-down growth. Raising the national saving rate is usually regressive and typically requires an authoritarian political culture or a high degree of centralization to make it work. This was pioneered in eighteenth-century Britain. First, aristocratic landowners used the power of the state to evict subsistence farmers and consolidate their holdings into enclosed estates. That boosted agricultural profits at the expense of the peasants, who were displaced from the countryside and forced into the cities. Their rising numbers limited their bargaining power with urban employers, which kept real wages from rising despite rising output per hour. That in turn boosted the profits of manufacturers, which reinvested those profits in developing additional capacity. In 1740, just 4 percent of British production was saved rather than consumed domestically. By the 1820s, the national saving rate had grown to 14 percent and Britain had become an industrial superpower that was exporting its excess manufacturing output to the rest of the world, especially its imperial colonies and the rapidly growing United States. Forced saving enabled productive investment that generated additional output that was then used to create additional investment. Saving by itself did not create wealth, but it was instrumental to the process of wealth creation because it could be used to fund investment.

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Britain did not pay for the first wave of its industrialization exclusively off the backs of its landless peasants, however. It also developed using elements of the high-wage model. While they became increasingly underpaid relative to the value of what they produced during the Industrial Revolution, British workers nevertheless continued to command higher pay than workers in much of the rest of Europe. Their high productivity and the favorable business climate pulled in capital from abroad, which allowed investment spending to consistently exceed national saving until after the end of the Napoleonic Wars. The difference was covered by the Dutch, who are estimated to have paid for about a third of Britain's total investment in the eighteenth century. The Dutch were willing to do this because British policies—including protective tariffs and what nowadays would be called intellectual property theft—had made investments in Britain more attractive than investments in the Netherlands and because at the time the Netherlands had a more mature economy with lower investment needs.¹ Like Britain, the United States used elements of both development strategies when it industrialized in the nineteenth century. Before the Civil War, the South used an exceptionally cruel form of agrarian feudalism to produce copious volumes of cotton, tobacco, and other cash crops. Southern agricultural output was an essential input for British manufacturers and generated the bulk of America's export earnings. The South's social system—extreme wealth and income inequality reinforced by the brutal subjugation of the enslaved labor force—also crushed consumption. Despite generating high saving rates, the planters had little interest in economic development. Instead of buying capital goods, they spent their surpluses buying additional enslaved workers and land. Southerners nevertheless contributed to America's industrialization because they were trapped behind high tariff barriers and were therefore forced customers of goods manufactured in the North. Southern agricultural exports generated by slave labor therefore helped pay, indirectly, for northern imports of advanced European technologies and machines that were then used to boost the North's manufacturing capacity.² Far more important to America's economic development, however, was the North's use of the high-wage model to fund its industrialization. Outside the slave states, abundant land, liberal institutions, and Yankee ingenuity meant that American workers consistently earned the highest pay in the world and enjoyed rapid increases in living standards. At the same time, high birth rates and high immigration made the U.S. domestic market the most impressive growth story in human history. The U.S. population grew from 4 million people at the time of the 1790 census to 40 million by the 1870 census and to roughly 80 million people by 1900. Protective tariffs biased that market in favor of American goods over imports. The combined result was that investments in America's economic development were incredibly attractive for European savers, especially the British. Foreign saving was therefore able to supplement domestic saving to pay for American imports of capital goods and lift U.S. investment without depressing U.S. consumption. Until the end of the nineteenth century, the United States consistently imported more goods than it exported even as its manufacturing output soared.

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After they arrived, many of these migrants started businesses using advanced technologies and skills from their home countries. Economists estimate that the value of this human capital inflow was worth several times the value of conventional foreign investment throughout the nineteenth century. The North's victory in the Civil War and the subsequent westward expansion of America's land borders solidified America's commitment to the high-wage model and increased its industrial potential even further. Rising inequality in the North in the decades after the end of the Civil War eventually depressed consumption relative to production, which meant that more investment could be funded internally. By the beginning of the twentieth century, America had become a net exporter.³ America's achievements attracted admirers and imitators, particularly in Germany and Japan. Friedrich List, one of the first theorists of the American System, had explicitly argued that America's internally vibrant but externally protected market was a model for what he hoped would be the unified German economy. A decade later, Erasmus Peshine Smith published his *Manual of Political Economy* (1853), which was perhaps the most important theoretical defense of America's developmental state. Like many in the antebellum United States, Smith saw abolitionism, protectionism, and mass immigration as part of a common program opposed to free trade and slavery. In his view, America's high wages—a product of high tariffs, abundant land, and, outside the South, human liberty—caused America's exceptional productivity. Expensive labor forced businesses to become more efficient and to invest in capital equipment. At the same time, rapid population growth expanded the domestic market and rewarded additional business investment.⁴

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close reading of the events of the past thirty years shows that the first option is the best explanation. Political and social changes within the surplus countries transferred purchasing power from workers, who spend most of their income on goods and services, to elites, who prefer to accumulate financial assets. This has occurred in a variety of ways in different countries. The Chinese hukou (household registration) system deprives hundreds of millions of urban workers access to government benefits for which they pay tax, for example, while German companies refuse to invest domestically despite rising profitability and regular losses on their investments abroad. These choices mechanically suppress consumption and investment relative to production, which in turn forces the rest of the world to spend more than they produce. The

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Large surpluses or deficits are not inherently good or bad. “Good imbalances” allow savers from richer surplus countries to earn healthy returns by financing development and rising living standards in deficit countries. This is what the United States did for much of the nineteenth century, when it imported mainly British capital to boost domestic investment to levels much higher than it could have otherwise achieved without squeezing American workers. More recently, except for a brief period in the late 1980s, South Korea consistently imported more than it exported in the decades from independence in 1948 until the Asian Financial Crisis in 1997. Korea is also one of the few countries to transition successfully from poor to rich. Norway, which was once one of the poorest countries in Western Europe, imported massive amounts of foreign savings in the form of large current account deficits in the 1970s to pay for the development of its offshore oil and natural gas fields. Once those fields began producing, Norwegians were able to repay their obligations and eventually amass a large stock of foreign assets purchased from their hydrocarbon profits. Had Norwegians been constrained in their ability to spend more than they earned, those resources never would have been developed. Both Norway and the world as a whole would have been poorer.¹⁸

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At the same time, surpluses can be bad. Savings have to go somewhere, but there is no guarantee that they will go into profitable investments. Germans, who have been such avid exporters of financial capital over the past two decades, are almost uniquely bad at investing abroad. Since the start of 1999, the German private sector collectively spent a little over €5.1 trillion acquiring assets in other countries. Yet over the same period, the amount of these foreign assets grew by only €4.8 trillion. The difference represents a valuation loss of 7 percent across nearly two decades thanks to such holdings as American subprime mortgages and Greek sovereign debt. Even after accounting for dividends and interest income, Germany’s foreign investments have done worse than the foreign investments owned by residents of almost every other rich country. A 2019 study by Franziska Hünnekes, Moritz Schularick, and Christoph Trebesch concluded that “Germany could have become about 2 to 3 trillion Euros richer [between 2009 and 2017] had its returns in global markets corresponded to those earned by Norway or Canada, respectively.” Strikingly, Germans’ poor returns have been caused almost entirely by their remarkable inability to pick the right stocks and bonds, rather than broader differences in asset allocation compared to savers in other countries. This

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This is a frequent phenomenon for countries on the periphery of the international financial system. Consider Turkey over the past few years. Between 2010 and 2018, the country went on an investment binge funded by borrowing from abroad. Turkey's current account deficit was consistently worth about 6 percent of its domestic income. This boosted output at the cost of rising debt. Attracting foreign money to cover this excess of spending over income required persistent currency depreciation beyond what would have been implied by differences in inflation: the real value of the Turkish lira fell by half between 2010 and the middle of 2018. Unsurprisingly, foreign savers grew increasingly skeptical of Turkey and mostly lent in debt that could only be repaid with U.S. dollars, not Turkish lira. (Think of Argentina's nineteenth-century gold-backed debts.) Interest rates also had to rise. The cost of a dollar-denominated business loan rose from about 4 percent in 2010 to 6 percent by the second half of 2018. Over the same period, interest rates on lira-denominated business loans soared from 9 percent to 28 percent. Eventually, foreign revulsion with Turkish assets slashed Turkish spending power, which in turn forced Turks to cut their consumption and investment to the point that they moved into a current account surplus by the middle of 2019.²⁰ Things look different when unneeded capital is pushed in from abroad. Instead of rising, interest rates in the deficit country stay stable—or even fall—as the imbalance grows. This is what happened to Spain after committing to join the euro. In the mid-1990s, Spaniards spent roughly as much as they earned, so the current account was nearly balanced. Meanwhile, benchmark interest rates were over 5 percent after subtracting inflation. From then until 2008, Spain's current account deficit steadily widened to roughly 10 percent of GDP. Yet over the same period, Spanish real interest rates dropped below 0 percent. Spain is a member of the euro area, so its currency could not move relative to its main trading partners in the rest of Europe. But Spanish wages and prices rose faster than in Spain's neighbors, so its real effective exchange rate rose by 18 percent during this period. By every possible measure, Spain's cost of capital was plunging even as Spaniards borrowed more and more from the rest of the world.

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These data suggest that there is less to China's external rebalancing than meets the eye. Even so, Chinese really are spending more on imports of commodities—particularly soybeans, dairy, and meat—and they really are spending more on foreign travel and schooling. That is good for China and good for the world. The progress China has achieved is fragile, however, because of its legacy of excessive debt and overinvestment. While tightening credit is necessary for China's internal rebalancing, the danger is that this will end up strangling investment before complementary reforms have succeeded in lifting household incomes and boosting domestic consumption. The net effect would be to depress domestic demand. That, in turn, would create two options. First, domestic production could fall to match the drop in domestic demand. Aggregate income would fall, likely through a combination of real wage cuts and much higher unemployment. China's political system might not survive that kind of social dislocation, and even if it could, the government has no interest in taking the risk of finding out. The likelier outcome is therefore that domestic production will fall by less than domestic demand, which necessarily means that China's trade surplus would expand through a decline in imports relative to exports. The Chinese government might choose to depreciate the yuan, for example, or find other ways to shift the burden of adjustment onto the rest of the world. Regardless of the specific mechanism, the global glut of excess production would get worse. From this perspective, China's "Made in China 2025" agenda can be understood as a preemptive measure to limit imports in preparation for the coming decline in domestic investment.

Similarly, the Chinese government's commitment to the Belt and Road Initiative (BRI) can best be understood as a way to manage the tradeoffs associated with its internal rebalancing, rather than as part of some strategic plan to gain territory or military bases. Recall that before 2008, the Chinese government dealt with overcapacity by exporting purchasing power and goods to Americans and Europeans. China avoided rising domestic indebtedness by accumulating trillions of dollars of U.S. and European financial assets and financing rising debt in the rest of the world. That became unsustainable, however, once American and European borrowers reached the limits of their debt capacity. The Chinese government adapted by encouraging additional domestic investment even at the cost of rising domestic debt. As we have seen, this has also proved unsustainable, which is why the Chinese government has changed course again. Over the past few years, the priority, with some exceptions, has been to constrain domestic credit growth and limit domestic investment. The real promise of the BRI, therefore, is that it will create new demand for Chinese exports of manufactured goods and construction services in Southeast Asia, South Asia, Africa, the Middle East, Eastern Europe, and Latin America. Chinese banks will lend to foreign governments and those governments will hire Chinese firms to build ports, railroads, electric grids, coal plants, telecoms, and more. So far, the BRI has been successful at generating demand for Chinese companies and Chinese workers outside China. But this has come at the cost of exporting many of the downsides of China's domestic development model to much of the rest of the world. Chinese lenders have little incentive to do due diligence, which has led to a raft of bad debts incurred by recipient governments. Chinese firms have little concern for the environmental impact of their projects. Political and cultural insensitivities have led to frictions between Chinese companies and host countries. Even if those problems could be overcome, the total addressable market of the BRI countries is far smaller than North America and Europe. It is therefore difficult to imagine China using the BRI to substitute for the loss of its traditional export markets.²³ All this has implications for how the ongoing trade war could affect the Chinese economy. China's reported GDP growth—which measures economic activity whether or not this activity is wealth enhancing—will be unaffected by trade war, no matter how severe, as long as China has debt capacity and the government is willing to use it. Losing access to export markets will affect the sustainability of the Chinese economy, however, because the government will likely respond by encouraging additional borrowing to finance increasingly unproductive investment, or possibly household debt. This makes the Chinese economy more vulnerable to a trade war than would be implied by its apparently low reliance on exports. So far, China has responded to U.S. tariffs by accelerating its import substitution, depreciating the yuan, and (modestly) accelerating domestic credit growth, including household debt.²⁴

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In the end, Beijing must choose among three difficult options: rising debt, rising unemployment, and wealth transfers from elites to ordinary households. To make matters more difficult, it will have to manage these tradeoffs at a time when its trade surplus is under stress, which puts further upward pressure either on debt or on unemployment. No matter what happens outside China, the government can continue to prop up growth as long as China's banks can continue to finance additional investment spending. There is some point, however, past which China will no longer be able to trade rising domestic indebtedness for lower unemployment. The sharp increase in private financial outflows after 2013 is a warning. Whether or not it is a deliberate process managed by the government, Chinese credit growth, and, with it, investment growth, will continue to slow.

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But high debt levels change the impact of more productive behavior in three important ways: • First, high levels of debt create uncertainty about how the costs of default and repayment will be distributed. Although this is well known in corporate finance, it is not part of traditional macroeconomics. The important point is that everyone in the economy changes their behavior to avoid bearing the costs of bad debt, and these changes in behavior undermine growth. The rich try to take their money out of the country, businesses cut investment, workers become uncooperative, middle-class savers pull their money out of the banking system to buy hard assets, and so on. Chinese debt levels are high enough that many of these financial distress processes have already started. Until debt is written down, reforms aimed at unleashing productivity will result in less wealth creation than otherwise. • In the past, Chinese provincial governments hit their GDP targets by borrowing in excess of the real growth capacity of the economy. Without the ability to borrow so cheaply, GDP would have grown much slower. This means that growth rates will slow significantly once debt levels stabilize. Moreover, China's debt levels are already so high that the priority should be reducing debt, rather than simply stabilizing it. Except in an economy in which all resources, including labor, are fully and productively used, increases or reductions in debt show up as changes in the growth rate. What had been a growth impulse must now move into reverse, which means that GDP will grow even slower than otherwise. • Last, because the Chinese banking system has not recognized the economic losses its lending has generated, China's GDP has been substantially overstated by the amount of bad loans. Investments are worthwhile only if they support future consumption and production capable of justifying the cost of the investment. The corollary is that the loans used to finance the investment are repaid at a competitive rate of interest. Many investments in China fail to meet that standard. Instead of increasing long-term growth, they reduce it by adding bad debt to the financial system that cannot be repaid without additional subsidies extracted from workers and retirees. The costs of these bad loans and bad investments will eventually be amortized over the adjustment period, however, and will necessarily lower future reported GDP by the amount that past reported GDP had been overstated.

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The trade surplus can be explained by an even greater slowdown in the growth rate of the volume of German goods imports. Germans spent fewer euros on imported goods and services in 2004 than in 2000 despite the impact of inflation and rising oil prices. Surpluses and net financial outflows were the inevitable results. The surpluses of the early 2000s persisted after Germany began to recover because of policy choices that constrained domestic spending and redistributed income to the rich.²⁴

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According to the Bundesbank, two factors were especially important. First, “wage moderation and the reduction in non-core payments readjusted the remuneration structure of labor.” Second, companies had shifted “production activities requiring a low-skilled workforce to foreign countries with a more favorable (wage) cost structure.” In other words, German companies had boosted their profitability at the expense of German employees by slashing pay and capital investment at home, by outsourcing work to low-paid contractors, and by moving operations abroad.

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Since workers are also customers, economywide wage cuts usually fail to increase profits. Germany companies got away with it because they could avoid Germany’s moribund domestic market by selling to foreigners. From 1991 to 1999, the German corporate sector had an average current account deficit worth about 2 percent of GDP. Corporations needed external finance to cover the difference between their investment needs and their cash flow from operations. Since the early 2000s, however, German businesses have been perennial savers and consistently generate a surplus worth more than 2 percent of GDP. The combination of sustained income from exports and lower domestic spending mechanically led to a higher national saving rate and a higher current account surplus.³⁶

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Inequality even rose within the ranks of the unionized thanks to the replacement of sectorwide collective bargaining with bespoke agreements negotiated by individual “works councils.” Real wages in the upper portion of the distribution grew while incomes for workers in the bottom half fell. The combined result, according to one study, is that “income concentration at the top decile in Germany today is even greater than it was during the industrialization period of 1871–1913.”

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A core argument of this book is that the distribution of purchasing power within a society affects its economic relations with the rest of the world. People who cannot afford to buy what they produce must rely on foreign demand for their output. Without sufficient foreign or domestic demand, they will have no choice but to produce less. When a large enough chunk of a country's income shifts from entities that spend most of what they earn on consumption to entities that spend less than they earn—the rich and the companies they control—that country is therefore likely to experience a shift toward a larger current account surplus or a smaller current account deficit.

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We have shown how this should work: developments in China and Germany since 1989 caused those countries to save too much and spend too little. Their experiences are instructive because together they cover much of what has happened in the other major surplus countries such as Japan, the Netherlands, and Singapore. The strange fact that needs explaining is that the United States has persistently run current account deficits despite sharing many of the characteristics of the stereotypical surplus country. Before we answer this question, it is important to understand why America should have been running current account surpluses for much of the past few decades. Start by looking at the household sector. Inequality in the United States has skyrocketed since the late 1970s. After accounting for taxes and government transfers, the share of U.S. national income going to those in the top tenth of the distribution rose from 30 percent to 40 percent of the total. The ultra-high earners within the top 1 percent drove most of that increase. Their gains came at the expense of those lower down. Americans in the bottom half of the distribution have experienced essentially no income growth since the late 1970s after accounting for taxes, inflation, and cash benefits from the government. These shifts in the income distribution have had predictable effects on the wealth distribution: the share of U.S. wealth held by the richest 1 percent of the population has soared from 22 percent to 42 percent, with almost all of that increase attributable to the richest 0.1 percent. The concentration of wealth has corresponded to an extreme concentration of capital income among the elite: about 70 percent of all earnings generated from owning assets now go to the richest 1 percent of Americans, up from 35 percent in the late 1970s.

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American companies have been even more restrained since the financial crisis. After subtracting inflation and depreciation, business investment spending in 2017 was 2 percent lower than in 2000. Investment jumped in 2018 thanks in part to the one-off incentives of tax cuts, but that was only enough to raise the average annual growth from 2000 to 2018 to just under 1 percent. With the notable exception of the shale producers and a few technology start-ups, most U.S. companies have been generating far more cash flow than they need to pay for their research, development, and investment spending. This surplus allowed American nonfinancial businesses to pay nearly 18 percent of the net value they generated to creditors and shareholders in 2010–14. Investors did better in that period than at any point since the 1920s. From the start of 2008 through the end of 2014, investors were paid 34 percent of the total increase in corporate net value added, which was similar to what happened in 2001–6. While there has been some rebalancing toward workers more recently, as in Germany, workers are still much worse off than before the 2000s.⁴

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More than 80 percent of the decline in private-sector employment between 2000 and 2003 can be directly attributed to the manufacturing sector. Losses were concentrated in the places and sectors most exposed to competition from manufacturers in countries where workers are paid far less than they are worth, most notably China. There was nothing inherently wrong with American manufacturers opening operations in China. The problem was that workers in China and elsewhere were unable to consume additional imports from the United States, which broke the link between rising trade and rising living standards.³⁶ In theory, the hit to manufacturing could have been offset by gains elsewhere in the economy. Yet despite the inflation of the health care, government, construction, finance, and education sectors—which accounted for most of the jobs created in the years before the financial crisis—the age-adjusted share of Americans with a job never surpassed the peak reached in 2000. The drop was particularly severe for those without college degrees. The collapse of the housing bubble eventually revealed the full extent of the damage wrought by deindustrialization.³⁷

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That is not what happened. While America's current account deficit has consistently been smaller than in 1998–2008, it has nevertheless persisted at about 2–3 percent each year. As before, this cannot be explained by excessive spending in the United States. American domestic demand has been exceptionally weak since the financial crisis. Personal consumption spending per person is more than 12 percent lower than it would have been if it had continued to follow the long-term pre-1998 trend. Business investment net of inflation and depreciation is finally higher than the peak reached in 2000, but spending on home building is still at levels associated with the recession of the early 1990s. Government investment spending is less than half what it was in the mid-2000s. The share of working-age Americans with a job remains roughly where it was in 2007 and significantly below where it was in 2000.

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The impact on American producers has been even worse than in the 2000s: as of the end of 2018, manufacturing output and manufacturing capacity were both lower than at the previous peak in 2008. Manufacturing employment was still down about 10 percent from its levels in 2006. America's trade deficit in manufactured goods (excluding refined petroleum products) was now worth more than 4 percent of GDP—its highest level since the nineteenth century. Worryingly, this deterioration in America's manufacturing trade position is mostly attributable to stagnant exports of advanced capital goods combined with soaring imports of competing products from abroad. The overall current account deficit has been kept in check by the transformation of the U.S. oil industry and by rising exports of American software (some of which is measured as foreign direct investment income for tax reasons).⁴¹ The persistence of the American current account deficit can only be explained by excessive saving abroad and the U.S. role in absorbing these excess savings. Calls for Americans to behave more prudently miss the point: it is not Americans who have decided to borrow too much. As long as there are Americans who want to borrow—and in every country, there are always people who are willing to borrow under the appropriate conditions—the U.S. financial sector will find them and lower interest rates and lending standards until loan targets are met. The financial system will continue to force adjustments in the real economy until savings decline. Either borrowing will rise or income will fall.
