American Enterprise Institute for Public Policy Research

Economic Outlook

April 2004

America Demands; China Supplies

By John H. Makin

Say's Law, named after French economist Jean-Baptiste Say (1767–1832), was promulgated at the time of the Industrial Revolution when some feared that purchasing power would be insufficient to absorb the ever-growing output of the newly mechanized economy. It states simply and reassuringly that supply creates its own demand. More specifically, the production of output tends to generate purchasing power equal to the value of that output.

Problems with Say's Law

The violent investment cycles and deflation that characterized the last thirty years of the nineteenth century together with America's Great Depression in the 1930s and Japan's current thirteen-year contraction have all demonstrated, if not the fallacy of Say's Law, a substantial need to modify it. Supply creates its own demand, but serious questions exist regarding the time period over which demand is created to absorb supply and the price level at which the market clears. Production includes production of the means of production (i.e., investment). Investors intend that the purchase price of new capital equipment will be less than the sales value of goods produced with that capital equipment. They intend to make a profit. If what turns out later to be too much capital equipment is produced, the investment is unprofitable because the value of goods sold falls short of investors' expectations. Maybe it is better to say that supply creates its own demand—eventually—and at some price level that may or may not render profitable the activities of all suppliers.

John H. Makin (jmakin@aei.org) is a resident scholar at AEI.

It is even trickier to apply Say's Law to an open economy and, in particular, to the current situation in the world economy, in which the locus of most demand growth is the United States and the locus of more and more output growth is China. (Other parts of Asia fit the supply role, but China is the largest and fastest-growing Asian country.) It may not be too much of an exaggeration to suggest a modified version of Say's Law for the early twenty-first century: an extraordinary expansion of supply generated by a large-scale shift of production to China, where the cost of labor is low, does not create its own demand in China, where saving rates are running at close to 40 percent, but markets may clear if U.S. demand growth rises faster than income. The faster the Asian supply grows relative to American/Western demand, the lower the price level at which markets will clear.

To put this in more contemporary terms, rapid production growth in Asia with attendant high saving by Asians is sustainable if Asian central banks recycle Asia's excess savings into loans to the U.S. government. Then the rising U.S. current account deficit is sustainable at current interest rates, incomes, and prices in the United States, not to mention at current exchange rates.

Slowing U.S. Demand

The problem that has emerged this year concerns U.S. demand growth. Sustained U.S. demand growth requires sustained growth of U.S. incomes. For the past year, rapid income growth for U.S.

households has been created through a combination of tax cuts and mortgage refinancings. But looking forward, the only source of a steady rise in disposable incomes for U.S. households would be employment growth, probably at a minimum of 200,000 per month, a moderate pace of job creation by historic standards.

The notion that U.S. employment growth would somehow pick up was dealt a serious blow with the appearance on March 5 of the February Payroll Employment Report. That report, which followed three consecutive months of disappointing payroll numbers, showed that the three-month average of monthly payroll increases dropped from 86,000 to 42,000. Only 21,000 jobs were added in February, and those came exclusively in the government sector; there were no net private sector job additions that month. The twelve-month average of payroll increases was 10,000 jobs. The average monthly increase during 1993, the last so-called jobless recovery, was 238,000 per month, after which the Federal Reserve saw fit to raise interest rates in February 1994.

More than a third of the 3.7 percent growth rate of last year's real spending and income resulted from tax cuts, rebates, and mortgage refinancings.

The earnings data in the payroll report underscore the difficulty of sustaining demand growth in the United States going forward without the benefit of tax cuts, rebates, or mortgage refinancings. Hourly earnings rose 1.6 percent during the year ending in February, the slowest growth rate since 1986. A year ago in February, the year-on-year growth rate of hourly earnings was 3.4 percent. Weekly earnings data, which include slight increases in hours worked, are nearly as weak with a 1.9 percent growth rate year-over-year compared to a 3.1 percent yearly growth rate for weekly earnings a year ago.

Despite weak payroll numbers and weak earnings data, consumption and retail sales have been supported by tax cuts and more consumer borrowing. During the year ending in January (the latest month for which comprehensive data are available), after-tax disposable income rose 5.2 percent—well ahead of the 1.9 percent growth rate of weekly earnings. But a fifth of that growth in nominal income came from tax cuts, with more than another fifth attributable to higher prices, including higher energy prices, which act as a tax on discretionary incomes. After these adjustments, real after-tax disposable income rose at a 3.7 percent rate during the year ending in January. Higher transfer payments and rental incomes made up the rest of the difference with the 1.9 percent annual growth rate in weekly wage income. In sum, more than a third of the 3.7 percent growth rate of last year's real spending and income resulted from tax cuts, rebates, and mortgage refinancings.

It took a sharp increase in borrowing to sustain spending growth in January of this year; consumer credit rose by $14.3 billion—more than double the expected rate. By February, the initial report on retail sales (excluding motor vehicles) showed no increase. The overall increase of 0.6 percent in February retail sales is attributable to a modest rise of auto sales in February driven by additional sales incentives. Some auto producers were disappointed by the February sales increase, and Ford actually cut its production schedules. Almost all of the increase in auto sales during February was by foreign automakers, thereby failing to provide much help to the U.S. auto industry.

Job Losses Over; Job Gains Absent

The last year has shown us that a powerful surge in growth, reaching over 6 percent at an annual rate during the second half of last year, has not been sufficient to do more than arrest job losses. U.S. firms have, on average, stopped laying off workers. Average monthly job losses in 2001 were 149,000. Average monthly job losses dropped to 5,000 in 2003.

U.S. firms have not resumed the hiring crucial for sustained income growth for a number of reasons. The basic reason has been that earning profits requires severe cost-containment measures since demand growth has not been strong enough to permit prices to rise. Labor productivity growth, the key to lower costs, has been strong as a reflection of two underlying realities. First, firms naturally laid off their least productive workers during 2001 and 2002. The most productive workers are still employed. Second, the remaining, more highly skilled workers have more capital to work with given the sharp increase in investment that occurred through the end of 2000. The higher capital-labor ratio provides a sound basis in theory for rising productivity. The effective capital-labor ratio has probably continued to rise over recent years as firms have become more sophisticated in extracting productivity gains from new forms of capital.

The need for cost containment, a reflection of weak pricing power, provides another underlying reason for static employment. For most firms, labor constitutes about two-thirds of total costs. Taking on new workers in many cases requires provision of health insurance, the cost of which has risen rapidly over the past two years. Firms attempting to maximize profits with a cost-containment strategy have been more inclined to extract higher productivity gains from the more skilled existing workforce than to hire new workers.

Asia Supplies the Extra Labor

In the context of globalization, China, and more broadly a labor abundant Asia, suggests another reason for weak U.S. employment gains in this cycle. China is rapidly increasing its capital stock in order to continue to increase employment of the huge reserve stock of labor flowing from its agricultural sector. China's prime minister, Wen Jiabao, delivering on March 5 China's equivalent of the State of the Union Address, expressed concern about the growing disparity in incomes between China's agricultural rural areas and the rapidly developing urban areas. Rapid job growth that absorbs the huge supply of agricultural labor into its industrial work force is necessary for social stability in China.

Additional demand for goods anywhere in the world produced with labor-intensive production methods is being met more and more by labor-rich Asian countries and, especially by China. America's imports from China have risen even more rapidly than exports to China. The merchandise trade deficit with China reached $126 billion in the year ending in January 2004, up sharply from an $83 billion deficit in 2002.

> The extraordinarily high level of Japanese currency intervention signals increasing concern about a slowdown in U.S. demand growth. Such a slowdown would cause the dollar to weaken while the overall level of demand growth in the United States would fall, thereby creating a double negative impact on the growth of demand for Japanese and Asian exports.

The supply created in China is not directly increasing demand growth in the United States. Rather, as China's output expands, its workers are sharply increasing savings. The negative impact on global demand is being cushioned by China's currency peg, which generates purchases of U.S. Treasury securities and, in turn, increases liquidity growth in the United States while keeping interest rates lower. It thereby encourages continued growth of U.S. spending. This is true of most Asian currency pegs, especially Japan's. The Japanese government has boosted intervention aimed at pegging the yen-dollar exchange rate to an annual rate of $600 billion so far this year.

The other problem arising from surging Chinese supply is a squeeze on the terms of trade for producers in industrial countries. China's rush to build productive capacity has pushed up industrial commodity prices sharply as well as prices of energy. These represent a cost increase for producers outside, as well as inside, of China. However, China's supply of manufactured goods restrains price increases for those goods in world markets, and so producers outside of Asia end up paying more for inputs while obtaining the same or lower prices for outputs, thereby compressing profit margins.

Unsustainable U.S. Demand Growth

The saving grace for U.S. producers and for U.S. growth in this environment where China's role as a rapidly emerging global supplier means that supply does not create its own demand has, as already noted, been extra demand growth in the United States arising from tax cuts, rebates, and mortgage refinancings. The primary support for a U.S. growth rate above 4 percent going forward continues to be the prospective positive impact of higher tax refunds—probably amounting to $40 billion over the first-half of this year. Higher fuel prices subtract the equivalent of about $10 billion from that stimulus, leaving the net stimulus at $30 billion, or slightly below 0.6 percent of GDP at an annual rate.

However, as we approach late spring, markets will become more aware of the fact that the fiscal stimulus turns into fiscal drag at mid-year, thereby suggesting a possible slowdown of U.S. growth to 3 percent or below during the second half of the year.

The recent sharp increase in concern in Europe and Japan about a weaker dollar, with its negative implications for continuation of their export-led growth, is probably inversely proportional to the confidence in a

continued U.S. economic expansion. Japan is pursuing its own version of attempting to make Say's Law operate on a global basis by recycling into U.S. financial markets over $100 billion worth of currency intervention (so far this year) aimed at keeping the yen from appreciating. The result, again, has been lower U.S. interest rates and a rapid increase in the growth rate of U.S. liquidity as reflected by a surge in the money supply. American consumers have benefited while American producers have been frustrated by an interruption in the dollar's weakening move that had been helping to address the global supply-demand imbalance. The weaker dollar increases the demand for U.S.-produced goods while reducing the demand for foreign-produced goods.

In short, a sharply weaker dollar is a symptom of the operation of a global Say's Law. Excess supply in Japan and elsewhere in Asia can either be sustained with the more rapid growth of domestic demand in Asia or by encouraging more rapid growth of demand for Asian products in the United States and in other advanced industrial countries. The extraordinarily high level of Japanese currency intervention signals increasing concern about a slowdown in U.S. demand growth. Such a slowdown would cause the dollar to weaken while the overall level of demand growth in the United States would fall, thereby creating a double negative impact on the growth of demand for Japanese and Asian exports.

Symptoms of Excess Supply

Exacerbation of an excess supply picture in the world economy as U.S. demand growth becomes inadequate to absorb all of the additional production coming from Asia would be reflected in prices determined in forward-looking markets. We would expect to see lower interest rates, weaker stock prices, and eventually, lower prices of industrial commodities once producers in Asia were forced to reduce the rate of increase of output. So far, as spring approaches, we have seen lower interest rates, lower stock prices, and just a hint of lower commodity prices. It may be that eventually surging Asian supply will create its own demand, but that is not going to happen with higher U.S. interest rates and slower demand growth in industrial countries. Rather, the best we can hope for is lower U.S. interest rates, another refinancing boom, and one more resulting boost of demand growth from the ever-reliable American consumer. Of course that scenario would require another rate cut by the Fed, and everyone knows that cannot happen.