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On Lessons Learned: China and Consumption Policy

"From the errors of others, a wise man corrects his own." – Publilius Syrus

China's persistent trade surpluses have become an international problem. Through tariffs, the United States has reduced its bilateral trade deficit with China, but now Europe is facing an onslaught of Chinese goods. Simply put, China's trade surplus is structural, a deliberate policy choice. When China joined the World Trade Organization at the turn of the century, its expanding trade surplus was called the "China Shock." What's occurring now is being dubbed "China Shock 2."

Economists mostly argue that the reason for this policy is that China's domestic consumption is too low. If China could lift consumption, more goods would be consumed at home, reducing exports. At this time, China has refused to make those sorts of changes.

In this report, we examine why we think Beijing has, thus far, refused to adopt consumption-expanding policies. First, we lay out the basic macroeconomic identities that show the mechanics of saving and investment. Second, we discuss the postwar economic structure that relied on the US providing the reserve currency and either supporting or actually supplying the reserve asset. We focus on Paul Volcker's role in establishing the Treasury as a global reserve

asset and how the US pressured Japan to reverse its export-promotion policies that it used so effectively from the 1970s into the early 1980s. Of course, Japan suffered a major bear market and three decades of economic stagnation as a result, and it's logical to assume that Chinese officials are keenly aware of this history, which is likely why they have rejected the "advice" from the West. We conclude by discussing the ramifications of China's rejection of an expanded consumption policy on the world economy and on markets.

The Macroeconomics

Mathematical or symbolic identities are, by design, true statements. This is because they are self-definitional. In other words, the entities themselves are defined within the identity. A familiar accounting identity is a balance sheet — assets will always equal liabilities plus equity. The fact that they "balance" is not all that meaningful, but how they balance offers important insights. For example, if liabilities exceed assets, equity is negative and the firm is in trouble.

Macroeconomics has identities as well. If we assume that Y =production (or income) and C =consumption, we can describe a subsistence economy as follows.

$$Y=C$$

In this economy, all that is produced is consumed. Such an economy is in a precarious position; any shortfall in Y means less C . If an economy such as this wants to create a buffer, then C must be less than Y , leading to:

$$Y=C+S$$

Here, S is saving. But that saving has to “go” somewhere, and where it goes in this simple economy is what we call investment, or I. Investment can be in the form of inventory or capital goods designed to improve production. And so:

$$S+C=C+I$$

To fill out the rest of the economy, if our simple example economy decides to provide public goods,¹ then government spending (G) is necessary, and it will need to be funded with taxes (Tx).

$$Tx+S+C=C+I+G$$

Finally, imports are funded by exports. Adding foreign trade makes the economy look like this (where M=imports and X=exports):

$$M+Tx+S+C=C+I+G+X$$

Rearranging terms gives you what is referred to as the “savings identity.” Another way of describing this identity is to say that private saving plus public saving plus foreign saving equals zero.

$$0=(I-S)+(G-Tx)+(X-M)$$

Let’s say a country wants to develop by lifting investment. It can accomplish this by suppressing consumption to boost private

¹ A public good is a good or service that can’t be easily segregated. If it is provided to anyone then it is usually provided to everyone, whether they pay for it or not. Classic public goods are national defense, fire protection, and policing. Since it is inefficient or suboptimal to try to restrict these goods to only those who pay, the private sector typically won’t provide them. Thus, government has traditionally provided these goods and used taxation to enforce payment.

saving. Increasing saving provides funding for expanded investment. If private saving is insufficient ($I > S$), the gap could be filled by public sector saving ($Tx > G$), with the government taxing its citizens to provide saving or running a trade deficit, effectively importing capital. If private sector saving exceeds investment ($S > I$), then the excess saving can be absorbed by the fiscal deficit ($G > Tx$) or by a trade surplus ($X > M$).

Historical Background

After World War II, US policymakers took great pains to avoid conditions that would lead to another global conflagration. That generation believed beggar-thy-neighbor policies² in the interwar period were a causal factor for the war. The US therefore wanted to support trade among free-world nations. Through the Bretton Woods Agreement, the US created conditions where nations could use dollars for global trade. All participating currencies were pegged to the dollar, and the dollar was pegged to gold at \$35 per ounce. Since the US held a commanding position in gold reserves, policymakers generally believed the system would be sustainable.

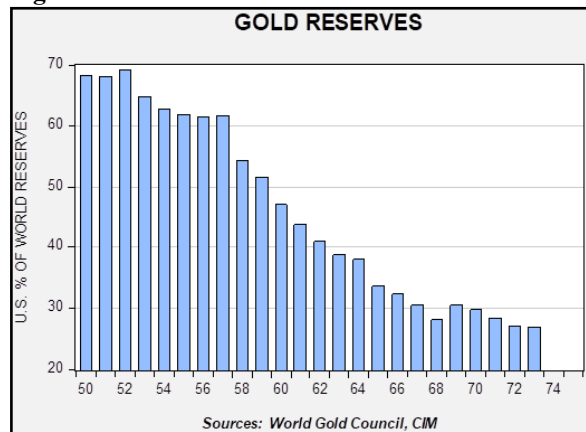
Figure 1 on the next page shows the US’s share of world gold reserves over time. Note that in the early 1950s, the US held almost 70% of total gold reserves. However, by the early 1960s, the flaws in the Bretton Woods system were becoming apparent. Economist Robert Triffin outlined the problem by noting that a nation providing the reserve currency is either forced to run persistent

² The term was coined by the economist Joan Robinson in the 1930s and referred to policies designed to improve the lot of the home country at the expense of other nations. This usually took the form of subsidies, currency devaluation, import quotas, and tariffs. An individual nation can benefit from these policies, but if all nations engage in them, it simply leads to a decline in foreign trade and weaker economic growth.

trade deficits to expand the global money supply or run a trade surplus that would contract the money supply. Persistently engaging in the former might lead to a loss of confidence, whereas the latter could trigger a global economic crisis. This became known as the “Triffin Dilemma.”

Figure 1 reflects what Triffin was describing. As the Europeans ran trade surpluses with the US and demanded gold for their dollar earnings, there was a steady drain on US gold reserves. By the late 1960s, the situation had become untenable.

Figure 1



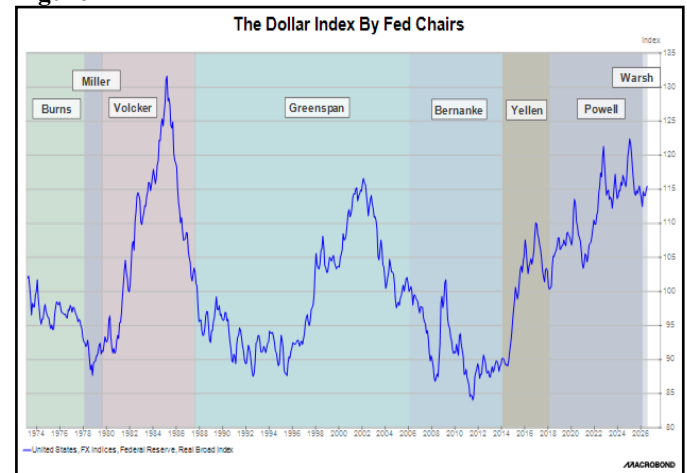
On August 15, 1971, the US suspended gold redemptions for US dollars. Although there is evidence to suggest President Nixon was not planning to end the Bretton Woods system but was merely trying to halt the gold drain, efforts to return to fixed exchange rates failed. The world moved to a floating exchange rate system with an uncertain reserve asset.

In the absence of gold, using US Treasuries would seem to be an alternative.³ However, persistent inflation problems and policy malaise undermined the status of Treasury debt.

³ In fact, the [US created just such an arrangement with Saudi Arabia](#) to recycle its dollar balances into Treasuries.

As shown in Figure 2, the dollar steadily depreciated leading into the term of Federal Reserve Chair Paul Volcker. On October 6, 1979, Volcker announced that the Fed would no longer target interest rates and would instead shift to targeting the money supply, allowing fed funds to find its market-clearing level for a given level of bank reserves. This action triggered a massive increase in interest rates, causing recessions in 1980 and 1981-82. As the chart shows, it also led to an epic dollar rally.

Figure 2



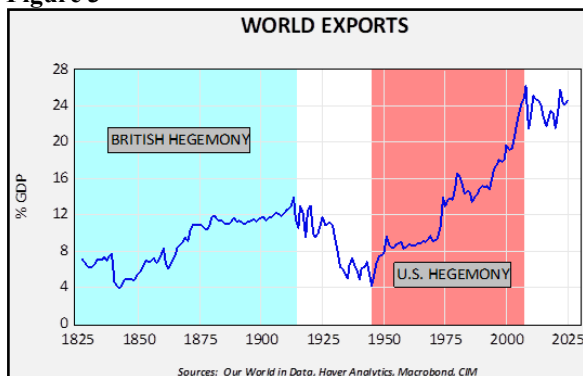
Although Volcker is credited with corralling inflation, his role in this was probably overstated. Deregulation and globalization likely played a larger role. But Volcker’s action proved that the US was willing to endure policy austerity to protect the ultimate value of Treasuries, thus cementing the Treasury as the global reserve asset.⁴

⁴ Chair Volcker returned early from the October 1979 IMF meetings where European officials sharply criticized US monetary policy, especially US dollar weakness. It was in the wake of that meeting that Volcker changed policy targets. See [Reflections on Monetary Policy 25 Years after October 1979](#). The driving factor behind the change from interest rate targeting to money supply targeting was a response to European criticism.

Shifting from gold to Treasuries for the global reserve asset fostered international trade. The supply of Treasuries is elastic compared to the supply of gold, meaning there were fewer supply constraints for nations accumulating reserves. Clearly, the risk was that the US would abuse its power as the issuer of the reserve asset. However, the alternative — a return to gold — meant a greater constraint on trade. When a country runs out of gold, it is reduced to barter.

Figure 3 offers a long-term view of globalization: It shows world exports scaled to global GDP starting around 1825, with color coding to indicate when Great Britain and the US each served as the global hegemon, i.e., the strong, dominant country that provides global security, order, and the reserve currency. In international relations, there is a concept, first outlined by Charles Kindleberger, called “Hegemonic Stability Theory,” which argues that the world works better with a functioning global hegemon.⁵ For example, the chart shows that under British hegemony, world exports grew until the onset of World War I, although the growth rate was likely constrained relative to the period of US hegemony due to the inelasticity of gold, among other factors.

Figure 3



⁵ For an in-depth discussion of the services a global hegemon provides, see our [WGR from 10/1/2018, "The Dollar Problem."](#)

It could be argued that Volcker's austerity policy worked too well, as the dollar's rapid rise triggered the Latin American debt crisis of the early 1980s and weakened the US industrial sector. In response, the Reagan administration called a meeting of the G-5 countries (the US, the UK, France, Japan, and West Germany) at the Plaza Hotel in New York in September 1985 to stem the dollar's strength. Not only was there a concerted intervention to sell dollars, but the countries involved pledged policy changes to depreciate the dollar.

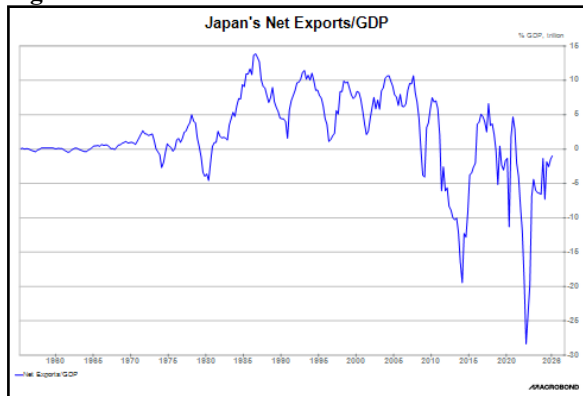
The country that garnered the most interest during this period was Japan. The dollar system offered foreign nations a path to development based on export promotion. Essentially, a nation could boost domestic saving by constraining consumption (as detailed in the first section of this report). Initially, this saving was used to support domestic investment. But once investment needs were mostly met, the policy could only be sustained by raising exports.

Although this policy was part of US hegemony, there were limits to US tolerance of export absorption. Japan was “ticking the boxes.” During the oil crisis, Japanese vehicles became popular for their fuel efficiency, while popular books, such as *Japan as Number One*, and movies, like *Gung Ho*, reflected American fears of Japan overtaking the US.

As shown in Figure 4 on the next page, Japan began running positive net export balances in the early 1980s, which persisted until after the Great Financial Crisis. After the Plaza Accord, the US pressured Japan to take policy steps to undermine its export-promotion policy, which included a sharp appreciation in the Japanese yen. Japan's monetary authorities increased liquidity to offset this currency appreciation, leading to a massive property and equity bubble. The

bursting of the bubble at the end of the 1980s led to over three decades of economic stagnation in Japan.

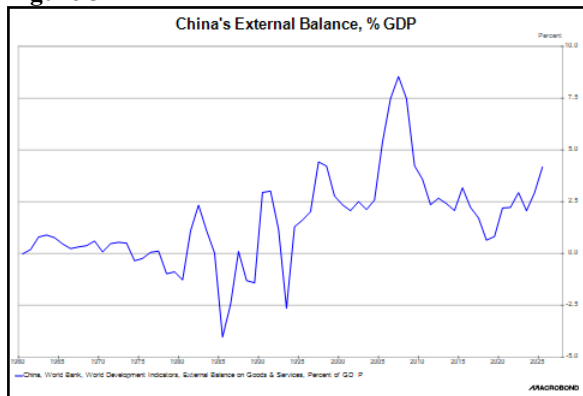
Figure 4



China's Lessons Learned

The consensus among economists is that China oversaves. This outcome is due to policy coordination, which includes an undervalued exchange rate, weak social safety net, financial repression,⁶ and industrial subsidies. These policies have led to persistent positive external balances as seen in Figure 5.

Figure 5

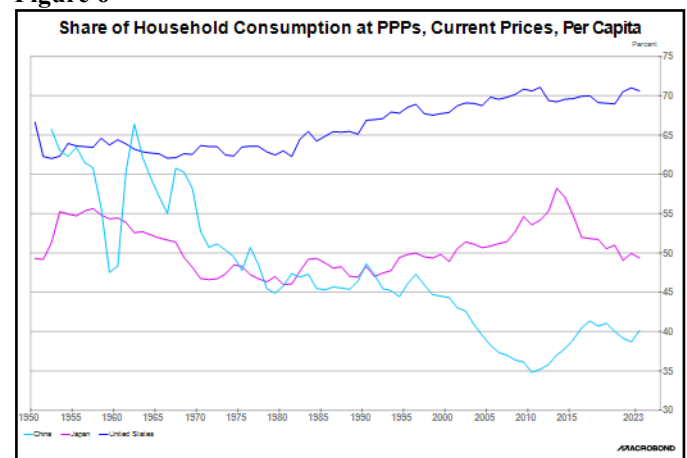


To take a deeper dive into the issues, it's useful to compare the shares of per-capita household consumption to gross domestic product in the US, Japan, and China.

⁶ This includes capital controls and low deposit interest rates.

As shown in Figure 6, China's household consumption per capita (light blue line) is significantly lower than that of the US (purple) and Japan (pink). The history of this figure across all three nations is interesting. For the US, note that the share of household consumption began rising after the Volcker shock. Essentially, the world wanted to acquire the reserve currency/reserve asset and forced external saving on the US, leading to rising American consumption.

Figure 6



In Japan, household consumption declined from the mid-1950s into the early 1980s. US policy then forced household consumption to rise, especially in the late 1990s, and it persistently rose until 2015, when the policies of Prime Minister Shinzo Abe reversed the trend. Finally, China's household consumption share remains low; it has risen modestly in recent years but continues to be depressed.

China's economic policies are being widely criticized. Although the bilateral US deficit with China has declined, mostly due to tariffs, the overall US external account is still under pressure. Some of China's exports are likely flowing through other countries via transshipments. In addition, China has increased exports to other nations, with Europe being its current target. Despite

the criticism, China seems to have no interest in adjusting its policies.

Robert Lighthizer, the US Trade Representative in President Trump's first term, offered this recent observation:

One of my fondest memories of my time as US trade representative involves a meeting I had with senior Japanese officials in 2017. They showed me a series of charts demonstrating how China was taking advantage of the free trade system by using currency manipulation, subsidies, and state-owned enterprises to decimate other economies. I smiled and told them that, in my role as deputy US trade representative in the 1980s, I had used very similar charts to explain Japan's behavior.

— *Foreign Affairs*, "The New Trade Order," May/June 2026

In sum, China seems to view Japan's acquiescence to US pressure in the late 1980s as a critical mistake, leading to profound economic stagnation. China appears determined not to repeat that error by following those same economic prescriptions. And so, by maintaining this posture, China is opting for a different economic outcome.

Ramifications

China's commitment to its export-promotion policies probably means it will avoid the economic stagnation experienced by Japan. If it continues the current policies, what are the market and economic effects?

China will face increasing trade barriers from nations around the world. Although the temptation to accept low-cost goods from China to contain inflation and expand consumer choice will be strong, the resulting de-industrialization and Chinese economic

dominance will be a cost that nations will likely find excessive.

If China faces increasing trade barriers, its deflation problems will only worsen. In the past, such as in the aftermath of the Great Financial Crisis, China has boosted public investment to absorb the excess saving. However, it already has extensive public sector goods. It could consider household consumption support via social spending, but doing so would be a form of complying with foreign demands.

The rest of the world will suffer various degrees of high costs and, in some cases, outright shortages. Although there will be attempts to apply tariffs and trade quotas to industries that need protection, while allowing imports of other goods,⁷ we doubt China will comply with such measures. Instead, it may tie access to desired goods with the acceptance of products that are under quotas and tariffs. The ability of nations to resist such pressures will be a function of availability elsewhere. If China turns out to be the primary source of the product, then it may not be possible to deploy effective trade restrictions.

In terms of markets, China's interest rates should decline as Western interest rates will likely rise. There will be pressure for the renminbi to appreciate, which China will need to resist if it plans to avoid the policies Japan followed in the late 1980s. In general, these trade conditions increasingly resemble those of the interwar period (see Figure 3).

Given that the world won't have the constraints of the gold standard to restrict liquidity expansion, another Great Depression isn't likely. However, persistent

⁷ US commentators will often say, "We'll accept China's toys and Christmas lights, but not its cars."

inflation will probably be the cost of avoiding that outcome.

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In this environment, hard assets should remain attractive along with equities. Long-duration fixed income will probably be pressured.

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