Capital and its Complements: A Summary

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Original link

The following is a non-technical summary of Brad DeLong's May 2008 paper Capital and Its Complements.

Adam Smith explained that in all countries with "security of property and tolerable administration of justice" citizens would spend all their money (capital), either on consumption or investment, causing the country's economy to grow. After some contention, later economic studies tended to bare this out: a shortage of capital wasn't always the bottleneck, but when it was, removing it could lead to extraordinarily rapid growth.

The problem for poor countries is that, because of high mortality rates (which require more children to have some survive) and low educational levels (which mean those children can find productive employment quickly), they have high population growth and thus low capital-to-labor ratios. Worse, trade allows you to spend your money buying manufactured goods from overseas, for which you have only your very cheap labor to provide in return. The result is that it requires an enormous amount of domestic investment to improve capital-to-labor ratios.

And so rich country economists made "the neoliberal bet" on behalf of poor countries: they hoped that loosening restrictions on international capital flows would send capital rushing in to poor countries and build their economies, the same way that Great Britain's massive investment in a young United States (in 1913 Britain's foreign assets equaled 60% of its domestic capital stock) built up that country.

But what ended up happening was exactly the opposite. Yes, NAFTA led US companies to invest the $20 to $30 billion a year on manufacturing in Mexico that its boosters predicted, but that investment was more than outweighed by the $30 to $40 billion a year fleeing the country from Mexico's wealthy wanting to invest it in the United States. Why? In part because the US was more politically stable, and thus a safer investment climate. And in part because the US treats its own workers so poorly — with productivity rising 35% since 2000 while real wages remain flat — it provides an excellent investment opportunity.

But meanwhile, all this investment in the US was dwarfed by the Chinese acquisition of our debt (and thus the political risk it represents). China needed to do this, since US purchase of their exports is the only thing funding the manufacturing-led industrialization of a massive portion of their economy; there would be massive dislocation if that funding dried up.

“Recognition of these facts came slowly.” First, Larry Summers said it was our unsustainable current account deficit. (That was the 1990s; today that deficit is four times as large.) Later, economists thought it must have been our large budget deficits. Then they began thinking it was the run-up in housing prices. But that, it is now clear to most economists, was the result of a bubble. And yet the flow of capital to the US continues. But, perhaps even more frighteningly, it could stop at any moment.