National Economics

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Abstract: With the slow recovery from the Global Economic Recession that began in 2008 and its lingering high unemployment in the United States and Europe, in spite of the best efforts of governments and central banks to remedy it, it may be helpful to suggest some adjustments in current economic thinking.

One adjustment may be found in the introduction of National Economics, in addition to macro and micro-economic theory, to better engage issues of free trade, the international outsourcing of manufacturing and research and development known as globalization, protectionism, Chinese mercantilism, and national investment policies, which may accompany the preparation of economic stimulus packages.

While free trade is generally acknowledged as a positive factor in contributing to economic growth, it has been used by mercantilists, both countries and corporations, as a cloak to achieve a National Income redistribution to enrich themselves at the expense of reducing employment, and wages and salaries within a country, and to substitute poorly made or low quality goods for goods of better quality.

One issue of National Economics that stands to be addressed is the contribution of Chinese mercantilism to the Global Economic Recession and its effect on unemployment rates. A major trading partner with the United States, Europe, and other countries, China uses a substantially undervalued currency compared to the U.S. dollar to increase its export of manufactured goods and economic growth rate, while suppressing the manufacturing sector in its trading partners.

Within many countries, large trade imbalances with China play a role in the distribution of National Income by depressing employment, wages, salaries, and investment. While mercantilists claim that these reductions in employment, wages, and salaries are offset by the proliferation of inexpensive Chinese goods, low quality goods do not compensate for reductions in employment and investment.

A second issue of National Economics that stands to be addressed, at least within the United States, is the need to prepare economic stimulus packages that represent a balance of new spending along with adjustments in entitlement programs and a reworking of the current regulatory environment, which policymakers use to reward corporate dinosaurs and financial manipulators, while the constrict the ability of small banks and lending institutions such as credit unions to make consumer loans and finance mortgages, with the effect of repressing the nation's economy.

Finally, some thoughts are given regarding the effect of Chinese mercantilism on Taiwan's economy, and Japan's effort to renew its economy.

Keywords: Bank problems, Chinese mercantilism, money class, national economics, stimulus.

Six years after the global financial crisis began in 2008, the world’s largest economies are growing, hiring a little faster, and creating more jobs but only with extraordinary aid from central banks (Wiseman, Kurtenbach and McDonald 2013). From the United States to Europe and Japan, central banks continue to pump cash into economies and keep interest rates low. Even the fast growing Chinese economy relies on government money poured into projects, and loans from state owned banks. Economists say that these economies may need help for years to come.

Still, the global economy is improving. The International Monetary Fund expected growth to rise to 3.6 percent from 2.9 percent for 2013. But this improvement “does not mean that a sustainable recovery is on firm footing,” said Angel Gurria, secretary general for the Organization for Economic Cooperation and Development. He added that major economies will continue to need a stimulus from “extraordinary monetary policies” to sustain their momentum.

Many economists think the stimulus will be needed longer, and “extraordinary monetary policies” carry risks. Critics and some policymakers in the U.S. Federal Reserve say that the cash central banks are pumping into the global financial system is flowing into stocks, bonds, and commodities, creating potential asset bubbles. Others warn that easy money may cause runaway inflation. Weaning the U.S. economy away from the financial support of the Federal Reserve may be tricky. If done too slowly, it could ignite inflation. If done too quickly, it might stop the recovery.

The slow recovery from the global recession and continued high unemployment in the United States and Europe might suggest some adjustments in current economic thinking. One adjustment may be found in the introduction of national economics to better engage issues of business environment, national investment,
research and development, banking policies, good
governance, and mercantilism, aspects of which may
form part of an economic stimulus package.

For example, while free trade is generally a positive
factor contributing to economic growth, it is sometimes
used by mercantilists, countries and corporations, as a
cloak to disguise their redistribution of national income
to enrich themselves while cutting jobs and lowering
real wages in a country, and substituting low quality
goods for better quality goods.

One issue of national economics that stands to be
addressed is the contribution of Chinese mercantilism
to the global economic recession and unemployment. A
major trade partner with the United States, Europe, and
other countries, China uses an undervalued currency
compared to the U.S. dollar to increase its exports.

In some countries, large trade imbalances with
China play a role in the redistribution of national
income by depressing employment, wages and
salaries, and investment. While some claim these
reductions are offset by the benefit to consumers of low
cost imports, low cost imports do not compensate for
job losses, reductions in real wages, lower domestic
investment, or low quality goods.

Another issue that stands to be addressed, at least
in the United States, is the need to prepare economic
stimulus packages that represent a balance of stimulus
spending with adjustments in entitlement programs,
which do not subsidize “financial dinosaurs.” In
addition, “reform” measures that restricted the ability of
small banks and other lending institutions such as
credit unions to make loans and mortgages, which
depressed the economy, suggests another issue that
needs to be addressed with real reform.

Some observations are given regarding Taiwan’s
imbalanced trade relationship with China, the economic
turnaround in the Philippines from a drive for good
governance, and Japan’s effort to renew its economy.

JAPAN

In December 2012 the election of Shinzo Abe as the
Prime Minister of Japan, making a rare second
appearance as Prime Minister, ushered in a set of
changes in economic policy that were well received by
the Japanese public and stock market. These changes
included a change in national attitude meant to renew
Japan’s sense of purpose as seen in Abe’s emphatic
declaration that “Japan is back” as well as changes in
fiscal policy and structural reforms.

A highly industrialized nation with the world’s third
largest economy, Japan needs a set of changes in
economic policy to revive itself from a prolonged period
of stagnation that began in the 1990’s, commonly
called its “lost decades,” and recover from the global
economic recession that began in 2008.

In addition, on March 11, 2011 a powerful
earthquake and tsunami caused a serious accident at
the Fukushima Dai-ichi nuclear power plant, affecting
four of its six reactors (Reuters 2013a). The breakdown
in cooling and subsequent meltdowns, explosions, and
release of radiation caused the surrounding area to be
evacuated. The accident and safety inspections at
other nuclear power plants caused Japan’s nuclear
power industry, which once provided a third of its
electricity, to practically come to a halt.

The accident at Fukushima affected Japan’s
economy. It disrupted its supply of electricity and
manufacturing sector, causing it to import more fossil
fuels. It continues to pose a problem with the ongoing
efforts to control the leak of radioactive cooling water,
dispose of fuel rods, and to shutdown and finally
entomb its reactors.

Other factors contributing to Japan’s stagnant
economy have been its aging population, and a low
birthrate, below replacement level, which have lowered
domestic demand and weakened its real estate market.
In addition, large overseas investments have reduced
domestic investments.

Shortly after taking office, in January 2013 Prime
Minister Abe unveiled his new monetary, fiscal, and
economic growth policies (Wang 2013a). Calling them
his “three arrows,” these urgent measures were
designed to stimulate the Japanese economy. The first
involved an expanded fiscal stimulus budgeting more
than 20 trillion yen (US$205 billion) for public sector
projects to maintain short-term economic stability.

(In theory, a stimulus applied to public sector
projects can bring relief to a country’s economy. Often
used for roads and public transportation, or water
supply and treatment facilities, it provides employment
for the construction industry and services. However,
skill is needed in choosing projects that are needed
and promote private sector activity or they become
wasteful and crowd out individual spending and
investment. A stimulus may also be administered as a
tax rebate or tax cut to increase private spending and investment.)

The second of Abe’s measure boldly applied relaxed monetary policies to hold down long-term interest rates, with the aim of raising Japan’s rate of inflation to 2 percent and keeping the exchange rate for the yen down (compared to the U.S. dollar) to promote exports and investment within Japan.

This desire to weaken the yen reflected the currency war, engaged in by other major industrial countries including the United States to increase exports by using low interest rates and relaxed monetary policies to devalue their currency. China has been the most successful in its manipulation, using a tightly controlled exchange rate to keep its currency devalued compared to the U.S. dollar.

Technically, relaxed monetary policies can promote investment within a country if skillfully applied. Low long-term interest rates can encourage businesses to invest in new opportunities and technology. But if kept in place for too long, low interest rates can discourage private savings and reduce income.

Japan needs new direction to support business investment and innovation, especially in its industry and electronics sector (Vogel 2013). One factor contributing to its economic decline in the 1990’s was the failure by government and industry to invest in technology and innovation. Some people believe that Japan can retrieve its former economic luster by letting its large companies revamp their workforce and encouraging them to invest in innovation, and supporting the appearance new start up companies, which are likely to introduce new technology and innovation.

With respect to Abe’s second measure, the desire to see a mild rate of inflation seemed to reflect the desire to break out of Japan’s deflationary price environment and achieve real economic growth rather than experience rapid price and wage inflation.

Abe’s third measure (Wang 2013a) involved developing a grand strategy to promote economic growth. This included a revival of Japanese industry by boosting technology investment. These policies became known as the “three arrows” of “Abenomics.”

Firing his first two arrows during his first 100 days in office, the Nikkei 225 Stock Average climbed past 14,000 points, and the yen fell below the psychologically important mark of 100 yen per U.S. dollar. Abe’s arrows were credited with prompting an increase in domestic consumption, an increase in exports, and an increase in some wages. After 20 years of stagnation, the Japanese economy was starting to see revival.

Abe fired his third arrow in June 2013, attempting to develop a strategy of reforms to promote economic growth. One involved foreign markets. Japan and the United States recently agreed on negotiations for Japan to join the Trans Pacific Partnership free trade zone around the Pacific Rim. Abe also reinstated Japan’s Regulatory Reform Council, and relaxed regulations on employment, the energy sector, environment, healthcare, and other areas of the economy while offering tax incentives to create a business friendly environment.

While some commentators questioned the timing of Abe’s third arrow, believing he should have shot off all three at the same time, structural reform often takes more time to formulate and implement than changes in monetary and fiscal policy. Structural reforms often require changes in regulation or new legislation. However, they are more likely to result in long-term benefits, while changes in monetary and fiscal policy often produce short-term benefits.

Some commentators credited Abe’s hard charging new policies with changing attitudes, instilling the belief Japan could revive itself. While some structural reforms take time to implement just as the structural deficiencies that caused the 2008 global economic crisis took time to manifest themselves, Abe was showing how changes in attitude that support economic growth can be implemented quickly.

The next month in July, voters handed Abe a victory in the upper house elections of the Diet, giving his Liberal Democratic Party (LDP) and ally New Komeito Party a majority in both chambers (Wang 2013a). His high approval rating, considered a key factor in the outcome of the elections, was expected to protect him from powerful interests in his party that will agitate against structural changes, which economists agree are badly needed. These changes include corporate tax breaks, greater participation of females in the workforce, participation in the Trans Pacific Partnership, and setting up special business zones around the country with reduced regulation (AFP 2013a).
Abe said the victory vindicated his economic policy blitz of a large stimulus and aggressive monetary easing, and pledged to push ahead with painful reforms aimed at fixing Japan’s economic woes (AFP 2013b). It gave his administration control of both legislative chambers at least until 2016, unblocking the legislative bottleneck that hampered the brief tenures of the past six prime ministers.

Abe said he would speed up decision making and policy implementation. In addition, a hike in the consumption tax for 2014 was on the books, seen as a key step to reducing the mountain of debt Japan has accumulated. But conscious of frightening shoppers, Abe said that he would make a final decision later in 2013 on whether to raise the sales tax, based on the current status of the economy.

By September 2013 Japan’s economy was on a roll, growing at a robust 3.8 percent with the stock market up 40 percent, about to overcome 15 years of deflation (Tabuchi 2013). Tokyo just won its bid to host the 2020 Summer Olympics, raising hopes of a boom in construction and investment. After weeks of internal debate, Abe approved the increase in Japan’s national sales tax from 5 percent to 8 percent, scheduled to take effect in April 2014, as part of his bid to rein in the country’s debt that had grown to more than twice the size of its economy or GDP.

(Economists sometimes debate the level of debt a country can sustain, which has focused on a level of about two times GDP. Too much debt and high interest payments can make it impossible for a country to repay its debt, forcing a restructuring.)

Some economists believe the increase in national sales tax may snuff out Japan’s recovery. Goushi Kataoka, economist at Mitsubishi UFJ Research and Consulting, said, “It’s nonsense. Japan is only midway to recovery and hasn’t fully escaped deflation.” These economists say raising taxes on spending is premature because it could dampen consumer spending, considered the weak link in Japan’s nascent recovery. If spending slumps, Japan could slide back into the deflationary morass that dogged it for 15 years, bringing down its economic revival.

On the other side, proponents of the tax increase want action. They fear a return to the political dysfunction that marred Japan for years through a succession of prime ministers. Even if its timing is suboptimal, it will demonstrate that Japan has the resolve to address its growing mountain of public debt.

To soften the blow, the government was considering a stimulus package of as much as 5 trillion yen (US$50 billion), to return the equivalent of 2 percentage points of the increase to consumers and companies. As an alternative, Japan’s business lobby called upon the government to slash the country’s relatively high corporate tax rates to make up for the anticipated drop in consumption.

Preparing a new stimulus to counter the need to raise taxes to service the country’s debt illustrated the need for Japan to restructure retirement programs. The plea by its business lobby to lower its relatively high corporate tax rates suggested another path of reform, using an increase in business spending as a stimulus.

Supporters of the tax increase, including Japan’s powerful Finance Ministry, argue it is needed to rein in the debt, largely accumulated due to the cost of caring for Japan’s aging population. In 2013 Japan’s national debt topped 1 quadrillion yen, more than twice the size of its GDP. Its sheer size worries economists who say a loss of confidence in the country’s long term economic sustainability could cause interest rates to rise, and increase the cost of servicing its debt.

Supporters of the tax increase, expected to generate about 8 trillion yen a year, acknowledge that it will not go far in paying down Japan’s debt, but feel it is important to “at least give the appearance” it is doing something about its debt. The Japanese hold an unspoken trust in their government and its bonds. If the government reneged on its plan to increase the tax, it could break that trust.

The tax, levied equally on all goods and services, will be easy to collect, cause a minimum of economic distortion, and be a more stable source of revenue than an income tax since everyone consumes in an aging Japan. At 5 percent, Japan’s current sales tax is among the lowest in the world. Another increase in the sales tax, laid out by Prime Minister Yoshihiko Noda, would raise the rate to 10 percent in October 2015. Japan’s sales tax represented a simpler approach to raising revenue than the U.S. income tax, which uses a complicated tax code.

Public opinion on the sales tax increase was divided. A survey showed 43 percent in favor, 49 percent opposed. Economists worried that it will slow the economy. The last time Japan raised its sales tax to 5 percent from 3 percent in April 1997 its economy plunged into a recession. However, one economist...
noted Japan now has a central bank willing to do “whatever it takes” to prop up the economy. Aggressive action by Bank of Japan Governor Haruhiko Kuroda helped stimulate the current recovery.

Speaking to the new parliament in October (AFP 2013c), Abe spent most of his time on the economy. He said, “Without actions, there will be no growth. This parliament is about taking action over growth strategy.” He added that, “We will promote business restructuring to spawn new businesses and back new start-up businesses,” and “push through electricity system reforms” to create a freer energy market.

Abe said he will submit legislation to change rigid business rules, which experts agree is necessary to free Japanese firms from red tape. While it was not immediately clear how these changes will be implemented, Abe had previously referred to special deregulation zones that will impose fewer rules on businesses. He pledged some deregulation of the electric power industry. Consumers now pay more for electricity as the operator of the Fukushima nuclear power plant struggles to deal with the clean up.

Japan needs to reform its energy sector (Goto 2013). More than two years have passed since the Fukushima nuclear disaster that caused it to effectively shut down all its nuclear reactors. Abe is committed to restoring the nuclear power industry. However, unresolved is the development of new energy resources such as solar and geothermal, which respect the loss of confidence in nuclear energy and can minimize global warming. Japan has untapped geothermal resources, and can use more solar energy in its southern islands.

Hopes are high that Abe will move forward on key issues that have hampered Japan’s economic growth for the past two decades. Analysts believe reform is needed to employ more of the potential female workforce, and reduce social welfare for the elderly as Japan has had low birth rates for decades and high longevity. Other reforms involve joining the Trans Pacific Partnership, and introducing a comprehensive vision to encourage economic competitiveness.

Abe’s economics have made Japanese society more confident about the economy (Lai 2013). A public opinion survey found that 40 percent of respondents thought the nation’s economy would improve over the next 12 months, the highest figure since 2002. His intent to join the Trans Pacific Partnership was seen as a way to promote structural reform in Japan, and he favors better relations with Taiwan.

Abe is relying on the Trans Pacific Partnership as a vehicle to drive his structural reform agenda (Stein and Vassilev 2013). The central purpose of these reforms is to improve Japan’s economic competitiveness and regain its edge in exports. The partnership will lead to lower costs for imports, increased regional access for Japanese exports, and reduce Japan’s reliance on trade with China.

The biggest challenge to joining the Trans Pacific Partnership is cutting Japanese tariff and barriers on key staples such as rice, a difficult change given the LDP’s rural voting base. Not surprisingly, Abe agreed to partially protect key agricultural sectors to persuade his party to support the rest of his agenda.

One area of concern for Abe’s agenda is how Japan’s labor laws keep unneeded workers on payroll (NYT 2013a). This gives workers a salary, but unneeded workers are required to show up for work with no work to do, an unpleasant situation. Abe wants to change that. In Japan, lifetime employment has long been the norm. Large-scale layoffs remain a social taboo, at least for Japan’s largest corporations. Abe wants to loosen rigid rules on job terminations for full-time workers.

Economists say bringing flexibility to the labor market in Japan would help struggling companies streamline bloated workforces, and better compete in the global economy. It would let businesses concentrate on pursuing innovative, promising lines of development. However, layoffs would hurt Japan’s social fabric, a country that has long prided itself on stability and relatively equitable incomes, although its stagnant economy has resulted in diminished job opportunities for college graduates and youth, and the widespread use of temporary or part time workers.

Large corporations are not always the best vehicles to achieve economic growth. Many people find employment in family businesses, start up companies, or small and medium size businesses. Smaller businesses are often able to fill special market niches, or pursue innovative ideas and opportunities more effectively than large organizations, which often focus on established product lines. Abe recognizes the need for Japan to be flexible in labor laws, and was supportive of start up companies and innovation, which can lead to hiring.
Japan has a strong social fabric (Halloran 2013). When in September it learned Tokyo had been selected as the site for the 2020 Olympic Games, banzai cheers could be heard from the north to the south. A senior retired official said, “Japan has been dispirited for two decades,” capped by the devastating earthquake, tsunami, and Fukushima nuclear disaster that occurred in 2011. About 21,000 people died in that disaster, which displaced nearly 290,000 people.

Many Japanese see the Olympics as a way to pull out of their national distress. They have a way of setting collective goals, and of striving to achieve them together. The 1964 Olympics held in Tokyo was integrated into Japanese Prime Minister Hayato Ikeda’s plan to double national income in 10 years, accomplished in a little more than five years. That was a time for the construction of highways, subways, and now widely acclaimed and copied Shinkansen high-speed railway.

Regarding social fabric, after inspecting the Fukushima nuclear plant, in September, Prime Minister Abe instructed Tokyo Electric Power Company (TEPCO), the operator, to decommission reactors 5 and 6, which survived (AP 2013a).

TEPCO had been unsure what to do with the surviving reactors. Abe wanted TEPCO to scrap all six reactors, so it could concentrate on pressing issues like stopping the leak of radioactive cooling water. Decommissioning, which will take years to accomplish, may cost 1 trillion yen (US$10 billion).

In October, it was noted Abe’s strong stand to protect Japan’s sovereignty over the Senkaku Islands and strengthen its military did not go over well with China (Hong and Zhao 2013). In the first half of 2013, Japan’s exports to China fell 17.1 percent, while imports from China fell 6.9 percent. China is still Japan’s largest trading partner. Under current trends, Japan will lose more market share than China.

Recognizing the importance of trade with China, Abe sought to engage China in discussions over its territorial disputes. Japanese firms have invested heavily in China to take advantage of its low labor costs and large market. However, Japan was taken aback by the anti-Japanese riots that recently occurred in China and its limits on exports of rare earths used to manufacture hybrid cars and other advanced products.

In summary, Abe’s economic policies have made a difference, reviving Japan’s economy. While his new policies began with a large stimulus for public works projects and relaxed monetary policy to reduce long-term interest rates, similar to the stimulus programs used by other countries, they did not stop there.

Most important was Abe’s introduction of a hard charging, pro-business attitude, influencing attitudes within government and business. It included changes in regulations and legislation to relieve businesses from an excess of red tape in labor relations, while it encourages technology, innovation, and start up companies. These attitudes rely heavily on the resourcefulness of the Japanese people.

In addition, Abe’s efforts to deal with the clean up at Fukushima reflected a sense of hope for Japan. Hope is an important motivation, especially for long depressed Japan. Belief that personal effort can result in a better future helps motivate people to work, and to work more productively, contributing to economic growth.

Added hope for Japan could come through efforts to develop clean energy resources. Japan can tap additional geothermal energy resources and use more solar energy. It has surveyed mineral rich areas under the Pacific Ocean, which could support mining of the ocean floor.

Abe’s policies highlighted an infrastructure of national attitudes. They involved both changes in fiscal and monetary policy, and changes in attitudes toward business and labor relations, and innovation that support economic growth. This idea of changing attitudes as a means to promote economic growth was taken up in the Philippines, although in a different context.

**THE PHILIPPINES**

Similar to Japan, the Philippines offers an example of a country, which, by changing its attitudes to be supportive of good business practices, quickly experienced rapid economic growth. Like Japan, this change in attitude began with a newly elected leader, President Benigno Aquino III, who taking office in June 2010, energetically sought to reform his country’s economy as the “sick man” of the Asia Pacific by overturning its culture of corruption to achieve real economic growth.

President Aquino wanted to let businesspeople focus clearly on good business practices of management, innovation, and investment as ways to
obtain a profitable return, instead of giving their attention to the nebulous, opaque world of corruption.

Good business practices improve an economy. They let businesses focus on providing goods and services, and improving quality, production, and innovation as well as sound relationships with customers and supplies, based on exchanges of information that are friendly, helpful, and open as a means of advancement, rather than bribes.

In a climate of good business practices, people are more likely to invest and start new businesses, assured that their efforts will be personally rewarded instead of absorbed by protection payments or otherwise diverted due to corruption. A climate of corruption imposes costs with payments unrelated to the production of goods and services, and diverts the focus of people away from their business.

While economic statistics do not typically measure good business practices or corruption, public opinion polls that survey attitudes toward the future, confidence, and spending can give indications about the two since corruption tends to erode confidence. In addition, some non-governmental organizations conduct surveys of business transparency and corruption in different countries.

Showing that his campaign against corruption was bearing fruit, in May 2013 President Benigno Aquino secured big wins in the mid-term elections seen as vital to his ambitious reform agenda (AFP 2013d). The elections gave his ruling Liberal Party and its allies control of both houses of the country’s Congress, easing the passage of legislation.

Aquino won a landslide victory in 2010 on a platform to fight corruption and improve the country’s standards of governance, widely blamed for the poverty that afflicts most of its population of about 100 million. During his first three years, with a majority support in the lower house of Congress, he was able to pass important and controversial legislation, which included the country’s first birth control program, and higher “sin” taxes on tobacco and alcohol.

Standards of governance, which fight corruption, among other aspects including uniform standards and measurements, are closely related to good business practices. Standards of governance affect economies.

For example, in 2013 the Russian government issued an honest economic forecast (Guriev 2013). Where President Vladimir Putin campaigned on a promise that Russia’s economy would grow at 5 to 6 percent, the growth rate was expected to average just 2.8 percent. Where the Russian government had been able to blame the country’s economic problems on the global economic slowdown, high oil prices, which prop up its economy as a major exporter of oil and natural gas, indicate that its low growth is due to “internal problems.” These involved a lack of effort to implement structural reforms related to poor governance, weak rule of law, and the tendency of state owned companies to drive out competition, which undermine its business climate and caused a flight of capital.

Russia’s political elite understands that the economy can achieve an annual growth rate of 5 to 6 percent. But the reforms needed to achieve such growth, which include fighting corruption, protecting private property rights, privatization, and the integration of Russia into the global economy, threaten their power. Those in power are more content to hold onto their piece of the pie, rather than implement the reforms needed to let the economy truly grow and risk their “cut” of the pie with a fair legal system and enforcement. Still, the Russian government’s release of an honest economic forecast was in itself seen as a step towards reform.

This commentary by a Russian economist suggests how structural reforms involving good governance, like the anti-corruption drive started by President Aquino, can result in an economic growth rate of two to three percent a year.

President Aquino has also sought to protect his country’s future in the South China Sea, including its rich fishing grounds, and tapping its potential undersea oil and natural gas reserves. However, its economic development became contested after China recently began to assert its territorial claims and expand its military presence in the region.

In July a Filipino commentator (Pitlo 2013) observed the South China Sea’s potential oil and natural gas reserves are comparable to European reserves, not the Persian Gulf, and most of its reserves are in “non-disputed” territory, close to coastal shorelines. In effect, much of the ongoing territorial disputes over the South China Sea reflect the value of its fishing and aquaculture resources, which account for one tenth of the world’s global fisheries catch, a multi-billion dollar industry.
For years, fishing in the South China Sea was not a geopolitical concern. Fishermen were oblivious to maritime boundaries and law. But this changed as dwindling fisheries around coastal areas and long-range commercial fishing pushed the frontier of fishing deeper within the South China Sea.

In April 2012, Chinese fishermen in Scarborough Shoal, about to be apprehended by the Philippines Coast Guard for illegal fishing and the capture of endangered species such as giant clams, radioed Chinese Maritime Surveillance ships for help. As China’s fishing fleet ventures further out, its maritime patrols in the South China Sea rose from 477 in 2005 to 1,235 in 2009.

After a prolonged standoff with the Philippines (Heydarian 2013a), by July China apparently secured control over Scarborough Shoal, and was seeking to gain control over the hydrocarbon rich Reed Bank off the Filipino island of Palawan. To protect its interest over Reed Bank, years ago the Philippines placed a tiny garrison at Second Thomas Shoal, a gateway to Reed Bank.

To help secure international support for its fishing and territorial claims to the South China Sea based on the internationally recognized Exclusive Economic Zone, in January 2013 the foreign ministers the Philippines and Japan expressed “mutual concern” over China’s assertiveness in its territorial claims over much of the South China Sea and East China Sea (Trajano 2013). Japan also planned to transfer new patrol boats to the Philippines Coast Guard.

The Philippines sees Japan as a major driver of its future economic growth. While China is the Association of Southeast Asian Nations’ (ASEAN) largest trading partner, Japan is still the Philippines top trading partner with total trade exceeding $13 billion in 2012, and is the Philippines’ top export market and primary source of investment, comprising around 35 percent of total foreign direct investment in 2012.

Unlike his predecessor, President Gloria Macapagal-Arroyo, President Aquino has been less receptive to Beijing’s commercial overtures. Elected on an anti-corruption platform, he moved to cancel certain Chinese funded projects initiated under President Arroyo that were marred by irregularities, while Japan generously expanded its assistance to support large infrastructure projects, including an extension of Manila’s Metro Rail Transit and airport construction. Japan also poured development funds into the island of Mindanao, where Aquino’s government brokered a hopeful framework for peace negotiations with the rebel Moro Islamic Liberation Front.

Contesting China’s claims over the South China Sea, the Philippines sought to initiate strategic partnerships with Japan and Australia, hoping to engage in closer military and maritime cooperation (Amador 2013).

In July, it was noted how President Aquino’s economic reforms have proved successful for the Philippines, the “sick man of Asia” (Pesek 2013). In August, its economic growth hit 7.8 percent in the first quarter of 2013, the highest in Asia (Reuters 2013b).

But in September, corruption scandals and a rebellion in Zamboanga on the southern island of Mindanao tested President Aquino (Heydarian 2013b), whose rise to power on a clean hands campaign indentified corruption as the main culprit for the country’s political decay and economic stagnation. His early anti-corruption efforts projected an image of change and strong leadership. Now he faced an outcry for deeper and more systematic reform, after a number of whistleblowers highlighted widespread corruption engulfing much of the legislature and bureaucracy, implicating dozens of high ranking officials and legislators. Stung by the breadth of the revelations, his administration seemed at a loss of how to respond.

According to testimonies, up to 28 legislators allegedly used bogus non-governmental organizations to channel discretionary “pork barrel” funds from the Priority Development Assistance Fund to pocket up to US$220 million over the past decade. The public demanded that President Aquino take a more explicit position to abolish the “pork barrel” system and bring the perpetrators to justice. His administration promised to place more checks and balances on the budget, revisit the system, and prosecute implicated officials while it consolidated its investigations into a solid case.

In addition to changes in attitude against corruption, natural disasters can affect a country and its economy. In November 2013, Typhoon Haiyan, one of the world’s most powerful typhoons with winds of 313 kilometers per hour, struck the Philippines with a powerful storm surge that turned coastal regions into wastelands, causing the loss of thousands of lives (Francisco). A slow relief effort, where for the first six days the government distributed only 50,000 “food packs,”
covering only 3 percent of the 1.73 million families affected, made the public angry. President Aquino’s televised appearances were rare, and he had incomplete information with telephone and power lines down.

Political analysts said public frustration with the slow relief effort could be a distraction, reducing the effect of Aquino’s reform agenda. Although the government had warned of the high winds and storm surge, evacuations were poorly enforced. Foreign aid agencies said relief was stretched thin after a big earthquake in Bohol province and displacement of people from fighting with rebels in the south. Aquino faced the twin challenges of speeding up relief, and rebuilding the nation’s confidence.

Aquino had planned to increase spending on roads and airports in 2014 to attract more investment. Since he took office, the stock index surged nearly 90 percent and foreign direct investment more than doubled.

A month after the typhoon struck, the city of Tacloban, at the center of the disaster, was getting back on its feet (AP 2013b). Rebuilding will take at least three years and depend on good governance and funds. In addition to aid from the United States and Taiwan, Japanese Defense Minister Itsunori Onodera and Australian Minister of Foreign Affairs Julia Bishop flew to Tacloban to check on the assistance that their governments provided. The World Bank approved US$500 million for recovery as well as technical assistance to design buildings able to withstand super typhoons.

Even this disaster was not stopping the country’s economic progress. President Aquino’s efforts toward good governance were having an effect, as were his efforts at improving ties with the United States, Japan, Australia, and Taiwan.

In summary, President Aquino was showing how simple changes in attitude, of fighting corruption and seeking good governance, can result in surprising economic growth and investment. At the same time, planning to build roads and airports that were needed in the Philippines, he was laying the foundation for long-term growth by improving the country’s transportation infrastructure.

TAIWAN

A country that achieved economic success based heavily on the flexibility of its business community, Taiwan has found its pursuit of the “China Dream” to achieve greater profits by relocating factories to China to reduce its economic growth, and placed itself under pressure to adopt China’s economic model, oriented toward the operation of large state owned enterprises or monopolies, accompanied by a loss of political freedom.

The “China Dream” believed that the relocation of factories to China would improve the cost competitiveness of Taiwanese exporters, and, by implication, Taiwan’s economic growth, by letting them take advantage of China’s low cost labor, electricity, and land. It apparently believed that the preservation of corporate profits would outweigh the loss of income to Taiwan from the loss of manufacturing jobs, and the loss of profits, which were unlikely to be reinvested in Taiwan.

While exporters are generally under pressure in the global economy to seek cost advantages, there are different export and manufacturing models, and various approaches to running a profitable business. Some manufacturers may seek cost advantages that are local, sometimes involving price breaks or streamlined regulation, or use advanced technology and innovation.

Other manufacturers may focus on providing quality and reliability, or developing new, innovative product lines and services. Others may focus on customer service, advertising and name brand recognition, or filling specialized market niches.

For many years, Taiwan, self absorbed in the development of its own economy and highly responsive to market changes and innovative, imposed barriers to the relocation of factories to China, especially those that manufactured computer chips and electronics. Its leaders believed that the relocation of its manufacturing sector, sought by some large Taiwanese companies, would drain the country’s economy.

Taiwan loosened its restrictions on investing in China. A numbers of companies relocated their factories to China, giving them lower costs for labor, electricity, and land as long as they met local requirements for extra payments and correct political behavior. Some Taiwanese businessmen had unhappy experiences and moved back to Taiwan, but many more stayed. Over time, thousands of Taiwanese managers and owners moved to China, mainly to its coastal cities across the Taiwan Strait.
Taiwan’s relocation of a significant portion of its manufacturing sector to China illustrates the economic problem of cheap capital, which reduces national investment and income in its quest for cheap labor and other low cost factors found overseas to maximize short-term profits. Cheap capital tends to treat labor as a line item. The transfer of cheap capital to China was sometimes associated with cheap labor management practices that involved harsh or unreasonable working conditions.

In recent years, problems of harsh working conditions arising from the transfer of cheap capital to China were partially redressed with the onset of labor strikes and concessions granted by management, and the unfavorable international publicity given to some businesses, who improved their treatment of labor.

In contrast, good capital treats labor as an asset, for which good management and innovation can improve productivity. Good management attempts to reward labor for its productivity and loyalty. Sound industrial and economic policy, pursued by government and business, recognizes that labor that is paid well is more likely to purchase the goods or services that are produced by business, and increase a country’s consumer demand, and savings and investment.

The problem of cheap capital is related to the problem of “hot money,” which quickly flows across international borders according to speculative trends, largely unrelated to real investment. Real investment includes improvements in the quality of goods, as well as environmental protection and energy efficiency in the production process. It tends to introduce new technology and employ people.

In addition, the relocation of factories overseas may reflect a hostile business climate within a country, which often takes the form of high tax rates and burdensome regulations. This did not appear to be the case with Taiwan.

In November 2013 the Taipei Times (2013a) reported how Taiwan’s third quarter GDP growth expanded at a much weaker than expected rate of 1.58 percent from a year earlier. A growing discrepancy between growth export orders and actual growth indicated a “hollowing out” of its domestic industry. Export orders grew by 3.2 percent while actual outbound shipments fell by 1.5 percent, as exporters produced more goods offshore.

In October, a record 52.9 percent of all export orders received by Taiwanese businesses were produced in their overseas factories. Information technology and communications, electronics, precision machinery and mechanical engineering were the major sectors that reported more than 50 percent of their production output from abroad. While overseas investment enabled Taiwanese businesses to generate profits by taking advantage of lower costs abroad, it did not contribute to domestic jobs.

The mild global recovery and relatively low interest rates, which should promote growth, did not lead to a strong recovery for Taiwan. The relocation of factories to China had weakened domestic investment. In real terms, most salaries in Taiwan had fallen to a level where they were 16 years ago.

Reflecting this weak economy, in October Taiwan’s Council for Economic Planning and Development reduced its economic growth forecast to 2.4 percent, while the jobless rate rose to 4.33 percent, and the unemployment rate for youth rose to 14.57 percent (Huang 2013a). The council had predicted the economy would achieve a “golden cross” with a growth rate of over 4 percent and jobless rate below 4 percent.

Apparently, the government’s economic plan is driven by the political goal of unification with China, not the goal of improving the economy. After five years in office, it has become clear that the harder President Ma Ying-jeou works, the worse the economy becomes. Income drops while the capital, technology, and talent that Taiwan accumulated in over 50 years of economic development is invested in China.

The signing of the Economic Cooperation Framework Agreement (ECFA) with China in 2010, which helped President Ma win reelection in 2012 with its promise of a favorable impact on the economy, proved excessively optimistic. Notwithstanding, the government continued to play up its belief that closer economic ties with China would help the economy. At the start of 2013 it played up its “golden cross” prediction. In June 2013, it signed the cross strait service trade agreement accompanied by the slogan “Taiwan can’t wait” to pressure the public and legislature into supporting it.

The ECFA may give an indication of the potential benefits of the cross strait service trade agreement (Tung 2013). In effect for over two and a half years, its benefits were limited to items on the “early harvest” trade list. In 2011 Taiwanese exports to China...
increased 8 percent while exports of items on the early harvest list fared slightly better at 9.9 percent. In 2012 Taiwanese exports to China increased 5.8 percent while exports of items on the early harvest list increased 2.3 percent so the ECFA did not had much benefit.

The ECFA was also touted on the basis it would attract foreign investment to Taiwan. But foreign investment in Taiwan remained low. In 2007 Taiwan attracted US$13.6 billion in foreign investment. In 2008 this dropped to US$6.7 billion. After 2009 it dropped to less than US$4.5 billion. In 2012 it was only US$4.2 billion.

In the 1990’s, international capital flows, including direct and investment in securities, amounted to a net outflow that averaged US$1.98 billion a year. During former President Chen Shui-bian’s eight years in office, it rose to US$13.23 billion, and rose to US$35.29 billion for the five years President Ma has been in office. In 2011 Taiwan’s net outflow of funds reached US$50.4 billion, and rose to US$52.3 billion in 2012.

Nor has the ECFA helped increase domestic investment. In the 1990’s the domestic investment rate was 28 percent. During President Chen’s eight years in office it was 23.7 percent. After President Ma’s five years in office it dropped to 17.2 percent, and for 2013 it was expected to drop to an all time low of 16.2 percent.

Over the past 20 years Taiwanese manufacturers increasingly relied on a business model where companies take orders for goods, but outsource production overseas, especially to China (Lin 2013). As this happened, salaries in Taiwan stagnated. The percentage of Taiwanese college graduates looking for work rose to 61 percent, and the average starting salary graduates can expect to earn is lower than it was 14 years ago. Taiwan’s economic growth model needs to change if it is to increase domestic investment, demand, local manufacturing, and employ its college graduates.

Under President Ma Ying-jeou, Taiwan has been living a “China dream,” which has proved to be false. In the late 1980’s Taiwan had a “Taiwan dream” where China looked to it for investment capital, technology, manufacturing equipment, and its business export model. Not much later, Taiwan began its “China dream,” wanting to embrace the “old country” rather than stay focused on Taiwan.

In the early 1990’s former President Lee Teng-hui got caught up in the “China dream.” He believed that Taiwan could become an economic hub for China’s one billion people when China wanted to absorb Taiwan’s manufacturing sector and export business. He later modified his dream to introduce his “No haste, be patient” policy, and ultimately abandoned the “China dream.”

After Lee Teng-hui left the Chinese Nationalist Party (KMT), the KMT took up the “China dream,” seen in the policies for cross strait economic and political integration that have been the centerpiece of President Ma Ying-jeou’s administration. President Ma’s promises to increase Taiwan’s economic growth to 6 percent and reduce unemployment to less than 3 percent during his first term of office were off the mark, for which he blamed the global economic recession, not the “China dream.”

In June 2013 the opposition Democratic Progressive Party (DPP) said it would defend against the opaque and unfair cross strait service trade agreement the Ma administration signed with China (Wang 2013b). While the DPP supports free trade, it opposed the lack of transparency in the negotiations, and the failure to inform affected sectors of Taiwan’s business community of its potential impact on Taiwan’s economy, especially on small and medium sized businesses, and the job market.

DPP mayor of Kaohsiung Chen Chu said, “Up to 4 million workers in the sector across the country could be impacted by the agreement.” Tainan’s mayor William Lai said that President Ma’s decision to sign the service trade agreement was “unwise” since the ECFA failed to live up to his pledge that it would benefit the economy.

Taiwanese businessman Liu Lu-chun, who installs surveillance cameras in Chiayi City, said, “It is very doubtful that we would be able to resist pressure from China and continue banning the installation of Chinese-made products.” He added, “If we totally open up the sector, then Taiwan’s traffic control system and video surveillance in public places would use electronic products made in China. These would be installed by Chinese contractors. This is a serious threat to our national security.”

Chen Wei-han, an interior decorator in New Taipei City, criticized the Ma administration “for letting Chinese companies come to Taiwan and steal our
business.” He added, “We will have more people out of work who are not earning any money. This government is killing the livelihoods of blue-collar workers.” Tsai Wen-ying, a home décor proprietor, said that once Taiwan opens up to Chinese companies, prices would be driven down and bad quality products would proliferate.

In June, a poll by Taiwan Indicator Survey Research (Wang 2013c) noted that when Taiwanese were asked if the ECFA had improved their financial position as claimed by the Ma administration, 48.9 percent said no, 28.3 percent agreed, and 22.8 percent declined to answer. With regard to the cross strait service trade agreement, 24.9 percent agreed with the government’s claim that its positive effects would outweigh the negative effects, 47.4 percent said its negative effects would outweigh the positive effects, and 24.4 percent declined to answer.

In July, a Taiwanese analyst noted that the ECFA and recently signed cross strait service trade agreement were not necessary (Wang 2013d) because the WTO was enough to deal with cross strait trade relationships. The agreements were part of a carefully crafted plan by President Ma Ying-jeou and Beijing for eventual unification. According to former DPP presidential advisor Huang Tien-lin, “The essence of these trade agreements was 70 percent political and 30 percent economic.” He said the agreement, along with President Ma’s planned free economic pilot zones, China’s Pingtan Comprehensive Experimental Zone and its Western Taiwan Straits Economic Zone formed part of Beijing’s strategic triangle to absorb Taiwan.

The other sides of the triangle included the establishment of representative offices on each other’s territory, and the “one China” framework, which Ma and the KMT advocate. The trade agreements will eventually make a one China market inevitable, and China’s Western Taiwan Straits Economic Zone project will absorb investment, personnel, and know how from Taiwan’s service providers.

Taiwanese civic groups said that the legislature should make a comprehensive study of the cross strait service trade agreement (Wang 2013e). Spokesman for Taiwan Democracy Watch, National Taiwan University professor Yen Chueh-an, said, “We oppose the Ma Ying-jeou’s administration’s inappropriate use of extra legislative sessions as well as the hasty passage of the service trade agreement.” The pact was signed without a significant assessment of its impact on hundreds of service sector businesses and the livelihoods of up to 5 million Taiwanese.

According to Huang (2013b), President Ma apparently wants Taiwan to believe that the service trade agreement is an “opportunity long due” and its deregulation of the financial services industry will bring business to Taiwan’s financial service sector. But as Taiwan’s financial service companies flock to China, invest in China, and open branches in Fujian Province, Taiwan will be left with little. Initial estimates suggested Taiwanese banks had transferred or are preparing to transfer NT$160 billion in core capital to China, which will marginalize Taiwan like the exodus of Taiwanese manufacturing to China.

The deregulation of yuan deposits in Taiwan that began in February saw more than NT$360 billion worth of Chinese yuan put in domestic and offshore accounts, a figure that is increasing at a rate of NT$50 billion a month, giving a projected annual total of NT$600 billion, equivalent to half of Taiwan’s average increase in M2 deposits of NT$1.2 trillion in the decade from 2001 to 2011.

While the purpose of these yuan deposits is to provide financial services in China, they squeeze out the credit available in Taiwan. Where in the past Taiwan experienced an exodus of manufacturing to China, Taiwanese manufacturers did not take out loans in Taiwan. Now Taiwanese banks are moving their capital into China or yuan denominated accounts, marginalizing Taiwanese businesses. This deregulation of yuan deposits helps explain the weak response to the moratorium on capital gains taxes on securities transactions. The exposure of Taiwanese banks to China, which reached US$30.4 billion or NT$913 billion, threatens to rival the United States in its exposure to China, leaving Taiwan’s financial industry largely in the hands of Beijing.

The Taipei Times (2013b) noted that the cross strait service trade agreement was signed behind closed doors, following negotiations between the KMT, chaired by President Ma, and the Chinese Communist Party. The result will harm the Taiwanese economy. Even the KMT’s legislative speaker said that he cannot endorse it. Two months later, President Ma attempted to have the KMT’s legislative speaker removed from office while he was on a trip outside the country.

The past dozen years have made it clear that the more Taiwan opens up to China, the worse its
The economy does, a factor that contributed to the downfall of the DPP government in the 2008 presidential elections (Huang 2013c). The Ma administration's deregulation of economic ties with China, the “moving over” of its manufacturing sector, and now its financial capital, has given Taiwan a “depressed economy” instead of its heralded “golden decade.”

The service trade agreement is not so much an economic issue as a political issue (Huang 2013d). Using economic means to spur unification is the main guiding principle behind China’s efforts to take control over Taiwan. The ECFA was a product of that principle. The service trade agreement is another pillar that will help China influence how Taiwanese vote, and achieve its goal of political unification.

From the perspective of the Ma administration, the agreement will help large Taiwanese corporations enter the Chinese market, and let Chinese capital and workers enter Taiwan. The KMT knows that letting Taiwan’s financial service industry enter China will further hollow out Taiwan and depress its economy. As Taiwanese lose heart in their country’s future, they will remain silent rather than object to unification.

In August, the Taipei Times (2013c) noted that Taiwan’s exports shrank 4.4 percent, and exports were up just 2.3 percent in the first seven months of the year. Taiwan’s Ministry of Finance attributed the sluggish annual growth to China’s economic woes caused by its overcapacity and rise in wages. Exports to China, including Hong Kong, climbed only 3.1 percent during the first seven months of 2013 compared to a year ago. Exports to the United States and Europe dropped at an annual rate of 1.1 percent and 6.9 percent in the same period, while sagging private consumption curtailed the demand for smartphones and other communication devices made by Taiwanese firms.

The ASEAN region may have the potential to prop up Taiwan’s exports and growth while growth in major destinations including China, the United States, and Europe slows down. Exports to six countries, including Malaysia and five other ASEAN members had increased 7.3 percent. ASEAN countries have become Taiwan’s second largest export destination, surpassing the United States, Europe, and Japan.

In October, Jang Show-ling, chairwoman of the economics department at National Taiwan University, called on the government to re-negotiate the cross-strait service trade agreement because of its unequal terms and violation of free trade principles (Chen and Chun 2013). She said that the Ma administration had kept the nation in the dark by not holding public hearings or involving the legislature before it was signed.

She added that opening beauty and hair dressing sectors to China would harm local businesses, and allowing Chinese investment in printing and telecommunications posed national security risks, and threatened freedom of speech and privacy in Taiwan.

She observed the agreement would only benefit larger corporations, and would have a destructive impact on the medium and small businesses that form 99 percent of Taiwan’s tertiary sector. When faced with competition from Chinese companies, whose method of operation is the monopolization of an entire market from production, manufacturing, to distribution and includes state owned enterprises which enjoy subsidies and protection, Taiwanese industries would fall, affecting more than 4 million Taiwanese workers.

Also in October, Taiwan’s Council for Economic Planning and Development admitted its prediction for a “golden cross” of a GDP growth rate over 4 percent and unemployment level below 4 percent would not occur (Huang 2013a).

An exodus of financial capital was causing Taiwan’s economy to suffer from a lack of personal consumption and domestic investment, key demand factors that can stimulate a recovery (Hong 2013). Rather than invest in domestic business, people were putting their money into real estate speculation. This increased housing prices, depressing further the morale of workers unable to purchase housing who struggled with salaries at a 16 year low and higher cost of living. This was creating a potential real estate bubble.

According to the Asian Development Bank, Taiwan came out last of the four Asian tigers in its economic growth. While this was partly due to the reduced demand for Taiwanese exports from the worldwide economic slowdown, the bank clearly stated the main reason Taiwan’s economy was unable to recover was the poor governance by President Ma Ying-jeou and his administration.

While elected on a platform of clean government, President Ma and his administration had acquired a reputation of conducting a politically motivated anti-corruption campaign, and poor fiscal management,
while his pro-unification policies with China deprived the Taiwanese people of needed assurance for their future.

In November, DPP legislators complained the Ma administration had opened a “back door” for Chinese investment to be exempt from restrictions in the planned free economic pilot zones before those zones were established, and the cross strait service trade agreement cleared the legislature (Wang 2013f). The Ministry of Economic Affairs had secretly bulletined an amended Measures Governing Investment Permit to the People of the Mainland, which lifted restrictions on the category, ratio, and amount for Chinese investments as long as there were no national security concerns.

Shortly afterwards, the pan green camp (DPP and Taiwan Solidarity Union) complained that the visit to Taiwan from China’s chairman of the Association for Relations Across the Taiwan Straits (ARATS) was an affront to Taiwanese sovereignty (Lee and Chung 2013). His visit was to focus attention on Taiwan’s “free economic pilot zones,” a project under which six harbors and the planned Taoyuan Aerotropolis will be designated models of economic liberalization. The pan green camp was concerned the project will spur a large influx of Chinese white collar workers, Chinese agricultural products, and investment in local businesses, previously off limits to Chinese capital.

The pan green camp had a point. Having achieved economic success without China, Taiwan needed to recalibrate its economic policies to renew its successful business model instead of inviting China to dominate it. China’s economic development model often uses the migration of Han Chinese to displace local populations, as seen in Tibet, Xinjiang, and Inner Mongolia.

On the other hand, representatives from Taiwan’s six major industrial and commercial associations urged lawmakers to expedite their ratification of the cross strait service trade agreement, amid protests of their lobbying as an attempt by big corporations to “sell the nation” (Lee and Hsu 2013). This coincided with the visit to Taiwan by the chairman of ARATS and his entourage of Chinese officials and business leaders.

One protester, Lai Chung-chiang, noted that most members of the six associations had business interests in China and ties with Chinese politicians. He noted that, for example, electronics conglomerate Kinpo Group had about 60,000 employees in China; and just before the agreement was signed, Capital Securities Corporation, Taiwan’s fourth largest brokerage house, announced it was looking for partners in China to open offices in Beijing, Shanghai, and Shenzhen.

In contrast to this pro-China policy by the Ma administration, the DPP administration of President Chen Shui-bian attempted to build trade relations with countries like India, and to strengthen Taiwan’s diplomatic ties with other countries, including in the Western Pacific. But his trade and diplomatic initiatives were only partly successful.

Some Taiwanese corporations felt drawn to China because of the promise of low cost labor, electricity, and land. Focused on their bottom line, corporations are easily enticed to relocate to China, to discover that other costs crop up in payments to local officials, theft of intellectual property, or pollution.

Many Taiwanese firms that relocate factories to China go across the Taiwan Strait. International corporations often place offices in Beijing where air pollution is a problem. Where U.S. and European governments seek to reduce carbon dioxide emissions at home, their reliance on Chinese imports and tacit approval of relocating their factories to China supports increased carbon dioxide emissions and air pollution as China obtains most of its electricity by burning coal with relatively few environmental restrictions.

Paradoxically, most Taiwanese of Chinese origin migrated to Taiwan over a period of centuries to get away from China, seeking a better future; and Taiwan has always enjoyed a vital trading relationship with many countries, including Europe, which colonized parts of Taiwan several centuries ago.

In October, China objected to a move by the European Parliament to build closer trade ties with Taiwan (AP 2013c). The EU is Taiwan’s fourth largest trading partner. Taiwan is the EU’s seventh largest trading partner in Asia. Taiwan’s Ministry of Foreign Affairs said it was “grateful” to the European Parliament.

Also in October, speaking to a group in Taipei, former U.S. Assistant of Secretary of State Kurt Campbell observed that it was in Taiwan’s interest to deepen its economic ties with other countries in Asia, as well as China (Shih 2013). He added while the emerging Trans Pacific Partnership offered enormous possibilities for a number of countries in the region, Taiwan needed to demonstrate the “political ambition” to join.
As if in response, speaking to a packed audience in New York City, in November, former Taiwanese Vice President Vincent Siew called on the United States and Taiwan to restart talks on a bilateral investment agreement (CNA 2013). He noted the United States was once Taiwan’s largest trading partner, but had slipped to third in the early 2000’s behind China and Japan, and emphasized the need to restart talks on a bilateral investment agreement as a step toward a free trade agreement.

Siew added that the United States should invite Taiwan to join the Trans Pacific Partnership, a U.S. backed trade agreement being negotiated among 12 countries along the Pacific Rim. He said that the fundamental purpose of his visit was to “bring Taiwan back to Washington’s attention.” While the ECFA had opened the “enormous” Chinese market to Taiwan, without access to other trade agreements Taiwan’s trade relations had become highly dependent on China, making them “unbalanced.” This diminished ties with the rest of the world. He suggested that this ran counter to U.S. interests, and said, “Taiwan’s marginalization undermines peoples’ confidence in our long-term economic prospects and discourages foreign and direct investment in Taiwan.” He expressed concern that the United States had neglected its faithful friend and ally.

Siew added “it makes perfect sense” for Washington to incorporate Taiwan into the Trans Pacific Partnership, which forms the economic center of its rebalancing strategy toward the Asia Pacific. He concluded by saying, “It is time for Washington to act.”

Illustrating Taiwan’s unbalanced economic relationship with China, in November it was alleged that Taiwan’s Eslite Bookstore refused to put on sale the book *Death of a Buddha – The Truth behind the Death of the 10th Panchen Lama*, written by exiled Chinese writer Yuan Hongbing and Tibetan author Namloyak Dhungser (Chao and Chung 2013).

Lee Wen-chin of the Asia-Pacific Political, Philosophical and Cultural Publishing House criticized Eslite. He likened the situation to Taiwan’s Martial Law era when the KMT government banned books published “outside the party.” It was unknown whether Eslite was worried that its stores in China and Hong Kong would be affected if it sold the book in Taiwan. Earlier, Locus Publishing director Rex How said that if the cross strait service trade agreement was ratified book distributors would be allowed to sell only books that “higher ups” had approved. The cross strait agreement seemed to be imposing a level of censorship upon Taiwan and its media. Other instances of censorship recently occurred on Taiwan, affecting a newspaper, and its cable television programming.

In November, the Taipei Times (2013d) editorialized that Taiwanese companies need to get rid of their “me too” mindset in an era of cut throat competition. They need to get rid of the business model, adopted by many companies, of competing with rivals by offering large discounts for nearly identical products, to develop winning strategies.

One winning strategy boosts research and development. Although increasing research and development is not a new idea, not many companies put it into practice since it takes time to see results. The Hon Hai Group, which owns Hon Hai Precision Industry, one of the world’s largest electronics manufacturing service providers, understands this more than other local manufacturers. In November it unveiled plans to invest US$40 million in research and development facilities in the United States, and develop facilities for high end products that included high margin components for telecommunications equipment and internet servers. Its decision to build facilities in the United States was unusual. Most Taiwanese companies opt for low wage countries when they move manufacturing overseas. But analysts considered it a smart move since it will help the firm shift to manufacturing high margin products, and break away from its business model of squeezing profits by manufacturing low margin products in China.

A maker of iPhones and iPads for Apple, Hon Hai Precision Industry saw early returns from its efforts to boost research and development, posting a gross margin of 7.07 percent for the third quarter of 2013. Terry Gou, chairman of Hon Hai, said that the Taiwanese manufacturing sector needs to strengthen research and development, and abandon the mindset of merely following leading international companies.

Another example may be MediaTek’s strategy of rolling out new chips earlier than rivals. Launching the first 8-core handset chips, its chips had a good selling point, well received by its clients, mostly in China. Chinese power management chipmaker Silergy is another example, investing heavily in research and development to integrate three chips into one for enhanced performance, which helped it obtain orders from companies such as General Electric and Oscram.
In summary, Taiwan gives an example of a country whose pursuit of the “China Dream” with the relocation of factories, managers, and technology to China reduced its economic growth rate, domestic investment, and real wages. Its earlier “Taiwan dream” gave a better example for economic growth, focused on developing its investment capital, technology, and manufacturing capabilities.

Taiwan illustrates the problem of cheap capital where some Taiwanese companies relocated their manufacturing to low wage countries like China to increase profits instead of focusing on other aspects of a successful business model, such as investing in research and development. A different illustration of cheap capital is found in how Steve Jobs of Apple Computers was fired from his own company after its leaders decided to focus on selling existing products for short term profit, having rejected his vision and passion for developing new products.

Taiwan’s recently signed cross strait service trade agreement gives a warning. It will lose much of its financial capital with the expected expansion of its financial services sector to China, and the expected influx of Chinese investment and workers will displace many of its small businesses. Gresham’s Law that bad money drives out good money applies to economies. Taiwan’s imbalanced trade relationship with China resulted in the displacement of its economic success with low economic growth.

To break out of its unsuccessful growth model of relocating its manufacturing and capital to China, Taiwan may consider the recent examples of Japan and Philippines and its own experience to encourage research and development, and favors domestic investment for the small and start up businesses that form a large part of its economy.

But Taiwan needs to adjust its policies to favor domestic investment instead of accommodating itself to the wishes of large corporations that want to relocate to China. Opening its doors to Chinese conglomerates that wish to impose their own business model and standards of governance, often tied to corruption and oppression, will be unlikely to help its economy or people.

**CHINESE MERCANTILISM**

Before turning to the United States, it may be helpful to briefly review China’s use of mercantilism as a contributing factor to the de-industrialization of Europe and the United States, which created a structural layer of unemployment and low investment similar to that experienced by Taiwan. In the United States at least, its accommodation of a largely one-sided trade relationship with China promoted its de-industrialization.

China’s use of mercantilism reflected a change in its economic policy adopted under the leadership of Deng Xiaoping in the early 1980’s. Seeing how the peasant communism of Mao Zedong impoverished the country, Deng sought to industrialize China, and said that to get rich is glorious. This opened the door to capitalism, although China continued to rely heavily on its state owned enterprises.

Like other Asian economic tigers, China believed it could industrialize quickly by focusing on exports. It used several factors to its advantage, including a large workforce of cheap labor, a tightly controlled currency exchange rate, and low cost electricity and land. It induced foreign manufacturers to relocate manufacturing to China, especially from Taiwan, Japan, and the United States. In addition, Chinese companies began to produce export goods.

For years China achieved a high economic growth rate, well above 7 percent, which helped maintain the legitimacy of its communist government to deal with various public protests against corruption by public officials, land seizures, political oppression, environmental problems, and other matters.

China got rich quick. Its undervalued currency compared to the U.S. dollar (estimates ranged from 20 to 50 percent), low wages, trade barriers, weak environmental protection, industrial espionage, and theft of intellectual property all served to increase exports. The U.S. trade deficit with China increased dramatically (U.S. Census Bureau 2014). In 2000 the trade deficit was $83 billion. By 2008 it increased to $268 billion, and currently runs over $300 billion. As a result, China accumulated over a trillion U.S. dollars in foreign exchange reserves. These factors suggest how Chinese mercantilism resulted in a large loss of jobs in the United States, probably several million.

In 2013 at the annual U.S.-China Strategic and Economic Dialogue in Washington, U.S. officials appealed to China’s self interest for deeper economic reform, including reform of its currency exchange rate, and halt of cyber espionage to steal trade secrets (Eckert and Yukhananov). Vice President Joe Biden
observed, “Your own plans call for the kinds of changes that have to take place, that are difficult, like here, but if they do, will benefit us both, including a free exchange rate, shifting to a consumption-led economy, enforcing intellectual property rights and renewing innovation.” U.S. businesses have long complained about Chinese policies that require foreigners to transfer technology to China to gain access to its market, barriers to farm exports, and regulatory favoritism toward Chinese state owned enterprises.

At the meeting, U.S. Treasury Secretary Jack Lew stressed the importance of reform, including China’s exchange rate, to shift its economic reliance on investment and exports to growth driven by consumption. A Chinese official said, “I think it will take us at least 5 years to resolve those issues and reach consensus.” In effect, China plans to keep its currency devalued to increase exports, with only modest concessions.

According to the Treasury Department (Eckert 2013), China acknowledged the U.S. concerns about the theft of intellectual property and trade secrets, and agreed to open its financial markets and move to a market derived currency exchange rate. U.S. politicians and labor groups have long accused China of suppressing the value of its currency, the yuan or renminbi, to make Chinese exports cheaper. The Treasury Department said the renminbi had appreciated by 16 percent against the dollar in inflation adjusted terms since June 2010. But the U.S. trade deficit continued to grow.

China is the largest foreign holder of U.S. Treasury bonds worth a total of $1.28 trillion (AFP 2013e). China has said that it and other emerging economies should have more say in international financial institutions such as the World Bank and International Monetary Fund (IMF) which has been headed by a European since its creation in 1944, and it has proposed a new international reserve currency to replace the U.S. dollar. An IMF reform has been in the works that would give more power to China and others, but effectively blocked by the United States.

The United States was not the only country to experience Chinese mercantilism. The publication in Taiwan (Wu 2013) of a translation of *China’s Silent Army* by Juan Pablo Cardenal and Heriberto Araujo, two Spanish journalists, also titled “China is Quietly Occupying the Whole World,” provides some illustrations.

From natural gas fields in Turkmenistan to bazaars in Dubai and mines in the Congo, the two authors found the Chinese are everywhere, grabbing resources. A miner in Peru said he felt he was living in a Chinese colony after a Chinese state owned company bought the mine where he works and town he lives in. Chinese companies were bringing Chinese workers to Africa while abusing local workers and damaging the environment.

China boosts its economy by exploiting workers with low wages while its cheap products cause a global deflation. Some countries are discontent with this. In 2004 residents in Elche, Spain burnt down a Chinese owned shoe warehouse after dozens of Chinese owned shoe stores forced local stores to close, and unemployment among local shoemakers rose as high as 30 percent.

In 2011, *Death by China*, authored by Peter Navarro, noted China employs every possible means from protectionism and exchange rate manipulation, cyber attacks, and espionage to gain resources around the world. In the United States, some people have been injured or killed by Chinese goods, including toxic food and toys, and contaminated medicine. Many large U.S. corporations ally themselves with Chinese state owned businesses, contributing to the decline of U.S. manufacturing.

Recently, China’s “princelings,” the offspring of senior Chinese officials who benefit from lavish privileges in education, employment, and business, had come under closer scrutiny (Minxin 2013). Bo Xilai, former secretary of the Chinese Communist Party in Chongqing and the son of one of Mao Zedong’s comrades, was recently convicted for corruption abuse of power, and sentenced to life in prison.

In 2013 the U.S. Securities and Exchange Commission announced it was investigating JPMorgan Chase’s hiring of princelings in Hong Kong, who apparently brought lucrative deals for the bank (Minxin). While recent scandals have put China’s princelings under scrutiny, they have become commodities for Western companies seeking to capitalize on their family, business, and political connections to secure multibillion dollar deals. The list of financial institutions that engage in such practices reads like a Who’s Who of investment banking.

While it cannot be concluded JP Morgan violated the U.S. Foreign Corrupt Practices Act by employing
the children of Chinese officials who oversaw companies that retained the bank to underwrite stock offerings, the case highlights the wooing of China’s princelings by prestigious Western educational institutions and businesses to advance their interests in the Chinese market.

The race to recruit Chinese princelings begins at the world’s leading universities. Since China has no universities that rival the Ivy League, Oxford, or Cambridge, senior Chinese officials prefer to send their children to these schools. China’s President Xi Jinping sent his daughter to Harvard under an assumed name, and Bo Xilai’s son was a student at Oxford and Harvard, and is studying at Columbia Law School.

Elite Western universities have identified China as a top market for fundraising and high end network building. They regard the attendance of princelings and nurturing ties with China’s political elite as good business. Western investment banks and multinational corporations view princelings the same way. But in China, with its pervasive corruption and tightly controlled media, the conduct of its princelings is largely unconstrained. In effect, western academic and business leaders have become complicit in helping the Chinese Communist Party perpetuate its rule at a hereditary level.

In 2013, Chinese authorities blocked access to an online Chinese language magazine started by the New York Times after it reported that JPMorgan Chase paid $1.8 million to a consulting firm secretly run by Wen Jiabao’s daughter Wen Ruchun, while American prosecutors were examining ties between Wen and the bank as part of a bribery investigation (Landler and Sanger).

A global economy needs to protect itself against mercantilism. Chinese mercantilism has weakened the economies of Taiwan, Europe and the United States by hollowing out their manufacturing sectors. It also stunts the creation of wealth through new technology and ideas with its lack of protection for intellectual property.

Some “free trade” advocates argued Chinese imports would be a boon to U.S. consumers with their low prices. Cheaply made Chinese goods flooded U.S. markets. What was not told was how Chinese imports reduced U.S. national income by cutting jobs and domestic investment, while providing consumers with a smaller range of low quality goods, and higher prices for medium quality goods.

In summary, much of China’s manufacturing sector is a product of mercantilism that sought to enrich itself quickly, taking advantage of a devalued currency, low wages, and trade barriers. Engaging in “dumping,” Chinese mercantilism attempts to build monopolies by driving out foreign manufacturers.

In contrast, the maquiladora factory system where northern border states in Mexico established free trade zones to encourage U.S. manufacturers to locate there, is generally viewed as successful. The salaries paid to Mexican workers help the Mexican economy, and let their workers to purchase more U.S. products, while U.S. manufacturers retain many functions within the United States.

UNITED STATES

In contrast to Japan and the Philippines, where new leaders ushered in a rapid turnaround in their economies, the United States is undergoing a slow recovery accompanied by high unemployment and a rapid increase in national debt, indicators of structural problems that need to be addressed, similar to Taiwan.

One structural problem facing the United States is the continued extension of unemployment benefits long past the system’s design. Many policymakers and editorial writers want to continue benefits without regard to why, after accumulating trillions of dollars in debt, the government has so little to show in new jobs.

Other structural problems seem to include the unwillingness of policymakers to adjust retirement ages for an aging population, the hollowing out of the country’s manufacturing sector, often to China, a poorly conducted aerospace program, and hostile business environment especially toward small and start up businesses.

Part of the decline in U.S. manufacturing may be attributed to Chinese mercantilism, where China advances its interests by using unfair trading practices such as a devalued currency, import barriers, low wages, the production of low quality goods, industrial espionage, theft of intellectual property, and burning of coal with few environmental restrictions, which increases global warming.

There is a difference between a stimulus that jump starts the economy compared to a stimulus that supports continued deficit spending and arises from poor fiscal management and an imbalanced budget.
Structural reforms may be needed if a stimulus is not enough to jump start an economy.

A stimulus needs quality of design. Its increase in demand should lead to new investment. It needs to be more than an injection of money into the financial system that adds liquidity to large banks and increases stock prices. To increase business investment and consumer spending it needs to increase the availability of capital and loans to small and start up businesses, existing businesses, and consumers.

In addition, some large corporations have evolved into financial dinosaurs, companies believed to be “too big to fail,” but need restructuring so that their upper management can focus on running a business that contributes to real economic growth instead of engaging in risky manipulations of the financial markets.

A related problem is the emergence of companies who accumulate large amounts of cash or financial holdings, but have little vision to invest it, or have reduced incentive to invest because of the recent appearance of a hostile business climate. A hostile business climate has appeared, largely reflecting recent changes in federal healthcare, employment, and taxation regulations that seem unduly burdensome.

CAPITAL AND THE MONEY CLASS

Businesses depend on capital. In some industries, businesses are capital intensive. In other industries, businesses are labor intensive; others rely on intellectual capital such as technology and inventions. In other sectors like agriculture, businesses require natural resources such as good farmland and water.

In the natural economy, businesses use capital to finance their operation or expansion, the introduction of new goods or services and the development of new resources. Businesses obtain capital internally or externally from investors with the sale of stock or bonds, or by obtaining loans. But the availability of capital to businesses and consumers is often impeded by the operation of the money class.

Rather than use money to supply businesses and consumers with loans and capital, the money class channels money into the financial markets to engage in large scale financial manipulations. In other words, the money class uses capital for a different purpose than capitalism, which uses capital in businesses to produce goods or services, which are consumed by society.

Using large amounts of money to engage in large scale manipulations of the financial markets, the money class may be associated with the appearance of asset bubbles, among other speculative activities, often international in scope as seen in the recent emergence of “hot money” flows across borders.

Size matters. Where financial markets traditionally operate based on a large numbers of individual investors, and presumably relatively small individual transactions, very large investors may manipulate entire markets, like the Hunt Brothers’ effort to manipulate the silver market in the late 1970’s, to create asset bubbles or depress a market for a buying opportunity. They may issue flawed securities, which buyers accept on the basis of the issuer's size rather than their intrinsic value.

Since the money class needs large amounts of capital to engage in large scale financial manipulations, to acquire capital it oppresses its availability to businesses and consumers. It often works with foreign mercantilists as seen in the decline of the U.S. manufacturing sector since a decrease in real investment means that more money is likely to be invested in the financial markets or real estate, creating asset bubbles.

This analysis about the money class offers the perspective that the availability of capital gives a motif for economic reform. Providing capital to businesses and entrepreneurs is an important means of economic advancement. Capitalism is more likely to succeed in generating income and wealth than schemes for the redistribution of wealth and higher taxes, which tend to dissipate wealth by treating it as income. The entrepreneurs who provide the heartbeat for capitalism tend to be found among small, start up companies, and pursue opportunities and innovation. They often include the founders of large companies such as Steve Jobs of Apple Computers.

While the financial manipulations of the money class create wealth, this wealth tends not to be used as capital. Its owners tend to lack the vision for business ventures that produce goods and services. As it restricts the operation of capitalism, the money class operates to impoverish a society.

This impoverishment of society by the money class reflects its restrictive and largely unproductive use of capital, which, by oppressing an entire economy, has a widespread effect. This distinguishes it from crony capitalism where the government intervenes to benefit
a few businesses, and may be seen as a form of corruption.

Regarding impoverishment, one commentator (Graham 2013) called the American dream into question, observing how in recent years inequality in wealth and income increased in the United States, which has long been viewed as a "land of opportunity," where those who work hard can succeed to get ahead.

Regarding inequality, Graham noted how from 1997 to 2007 the share of income accruing to the top one percent of households in the United States increased 13.5 percent, equivalent to shifting $1.1 trillion of total annual income to these families, more than the total income of the bottom 40 percent of households. While this measurement does not present a complete picture of American society, shifts in inequality can send important signals, affecting people’s beliefs, behavior, and work ethic.

If income is perceived as a reward for individual effort, it can give people hope. But if income is perceived to result from an unfair system, it can undermine the motivation of people to work and invest. Current trends are a concern since economic mobility in the United States has declined. Without a belief that hard work begets opportunity, people are less likely to invest in education, undermining the skills of the workforce.

Graham noted where some argue as long as the United States maintains its economic dynamism, leadership in technological innovation, and attractiveness to immigrants, its inequality in wealth and income is irrelevant, others perceive its growing inequality in income is making it lose its attractiveness to its people and overseas.

One reason for the growing inequality may be found in how U.S. economic policies of de-industrialization and weak investment, which otherwise would employ people with skills, have cutback the middle class. Another reason may be found in the growth of societal problems, including a lack of two parent families, divorce, substance abuse, and gambling addictions that absorb income. Divorce, for example, creates legal expenses, impedes the education and care of children, and its division of property and income results in less total income for a family, which it could otherwise invest.

Still, wealth is always redistributed. Wealth is constantly redistributed by natural means such as the passing of an inheritance to family members, and by unnatural means such as the fees charged by attorneys and accountants, and federal estate taxes.

Wealth is also effectively redistributed by higher taxes on high wage earners, and by means testing various benefits. A broad concept of assets, commonly used to generate income, the redistribution of wealth does not always produce more income.

The money class is a class, although not the class that many people would think. It generally involves those who obtain income from large scale manipulations of financial markets, and their political supporters, often found in government, and among various non-governmental organizations.

Regarding the money class, economist Robert Shiller (2013) asked whether too many of the United States’ most talented young people are choosing careers in finance, especially trading, speculation, and other “unproductive” activities that generally lack investment that increases the production of goods and services, or quality of life.

Shiller noted how, according to one study, much of the increase in financial activity by graduates of elite universities took place in the more speculative fields at the expense of traditional finance. From 1950 to 2006, activity in credit intermediation, or lending that includes traditional banking, declined compared to “other finance,” including securities, commodities, venture capital, private equity, hedge funds, trusts, investment banking, and other investment activities. At the same time, salaries in “other finance” skyrocketed.

Are too many people employed in speculation? Trading, a common vehicle for speculators, provides a service in the sense of letting people leave and enter a market, and sorting out information about businesses to judge their true value. But while trading may be said to help allocate resources to the most promising businesses, in another sense it is a selfish activity, unrelated to the employment of capital in enterprises that produce real goods and services.

Shiller observed how these bright young college graduates engaged in “other” financial activity tend to add a negative value to the economy, skimming the best business deals, while the bad assets they reject, such as the subprime mortgage securities that fueled the 2008 financial crisis, are foisted upon less knowledgeable investors.
Shiller noted that since the Gramm-Leach-Bliley Act of 1999 repealed Glass-Steagall, bankers have tended to act like feudal lords. To partially correct for the repeal of Glass-Steagall (and implicitly recognizing its repeal was an error), the Dodd-Frank Act of 2012 imposed the Volcker rule, which bars proprietary trading by commercial banks. But much more could have been done.

In other words, the repeal of Glass-Steagall was a mistake. It allowed the creation of financial dinosaurs, greedy for the short term profits obtained by market manipulations, including the sale of mortgage backed securities that break the normal relationship between a borrower and lender.

Shiller noted how to many observers, Glass-Steagall made no sense. Why should banks not be allowed to engage in any business they want, as least as long as we have regulators to ensure that the activities do not jeopardize the entire financial infrastructure?

Implemented after the stock market crash of 1929, Glass-Steagall represented some hard learned lessons. One was the importance of separating financial companies according to their economic structure. Reliance on regulators is no substitute for the separation of banks by major line of business.

Businesses have different economic structures. Banks provide loans to businesses and consumers. There are reasons banks should not be allowed to engage in any business they want. The role of banks is to provide loans to businesses and consumers. Letting them invest in financial markets diverts their attention from their business of making loans. As they increase in size, they may manipulate markets.

Shiller observed how the main advantages of the original Glass-Steagall Act may have been more sociological than technical, changing their business culture. By keeping their deal making business separate, banks can focus on their core business.

After the trillion dollar bankruptcy of Lehman Brothers in 2008, there was no shortage of ideas to reform the banking system, including the breaking up of big banks into retail and investment arms as they had been under the Glass-Steagall Act of 1933 (Elliott and Treanor 2013). Reformers were not limited to the Occupy Wall Street movement, but included Paul Volcker, former chairman of the Federal Reserve, who supported moves to prevent banks from engaging in speculative trading that did not benefit their customers.

In Britain, the government backed plans to force banks to separate high street operations from investment banking. While reformers and regulators argued for raising the capital reserve ratio for banks, one banker, Douglas Flint, said, “The focus has been on capital because we can measure it. However, the real issue is about culture.” Efforts to change that culture focused on the bonus system. When the crisis hit, the finger was pointed at the bonuses paid to bankers, which encouraged risk taking since bankers stood to earn large rewards with no penalty for losses.

Some observers noted how risk management was almost non-existent in some of these situations. The risks taken far exceeded the amount that an entity could withstand and be viable. In the United States, the federal government played a role in essentially forcing lenders to accept low income applications. There seemed to be push for making loans when income was insufficient.

The London City regulator was one of the first in Europe to stop all cash bonuses and demand a proportion be paid in shares and spread over three years, to make bankers think about long term return (Elliott and Treanor). Still, bankers were paid bonuses. In 2013 bonuses were headed back towards the levels seen before the crash in 2006-2007.

Another way to change bank culture is to change their operation (Elliott and Treanor). In Britain, the Vickers proposals required placing a fence between the high street banks and “casino” style investment banks. While its proposals were more radical than expected by some, they were moderate compared to the U.S. Glass-Steagall with its full separation between investment banks and high street banks, a reform that lasted until 1999, when lobbying by investment banks saw it swept away.

Howard Davies (2014) noted how London’s huge financial center with outsized domestic banks, may be costly to taxpayers as seen in Iceland and Ireland where banks outgrew the ability of the government to bail them out when needed. He believes London’s outsized domestic banks are harming the real economy by siphoning off talent and resources that could be better employed elsewhere.

Davies pointed out a recent speech by Andy Haldane at the central bank questioned the British
financial sector’s contribution to the economy. He added a recent paper by Robin Greenwood and David Scharfstein at Harvard said the share of finance in the U.S. GDP almost doubled between 1980 and 2006 just before the onset of the global financial crisis. The two main factors driving that increase were an expansion of credit and rise of asset management, meaning higher incomes for those in “other finance.”

Davies also referred to a study by Stephen Cecchetti and Enisse Kharroubi at the Bank for International Settlements, which found a negative correlation between the financial sector’s share of GDP and a healthy economy. They observed how research intensive firms that employ scientists and mathematicians suffer as speculative finance blooms, which employs such specialists as programmers.

In effect, the repeal of Glass-Steagall during the Clinton administration may be said to represent the start of an anti-reform movement, largely continued by the Bush and Obama administrations. This anti-reform movement included policies that supported a pattern of de-industrialization, and weak investment into research and development.

One aspect of this de-industrialization included the development of a one-sided trading relation with China, and decline of the U.S. manufacturing sector. This continued under the Bush administration. While the Obama administration began to resist the one-sided trade with China, the trade deficit with China continued to increase.

The Bush administration also oversaw the loss of the U.S. rare earths mining industry. It allowed a small but valuable industry to be replaced by Chinese exports of rare earths in a campaign to create an artificial monopoly and require manufacturers using rare earths to relocate to China. Their monopoly on rare earths had repercussion felt by the United States, Europe, and Japan.

The repeal of Glass-Steagall may be suggested as a potential source of some of the bank problems that have appeared in the United States in recent years.

**BANK PROBLEMS**

In recent years, bank problems have appeared in the United States, under two main categories. One takes the form of predatory financial practices, which includes excessive credit card interest rates as well as large scale manipulations of the financial markets and inappropriate sales of mortgage backed securities. The other takes the form of banking regulations, ostensibly to correct the ills of large banks, which oppress small banks and local financial institutions, and depress the economy.

The problems are related. The more harm the large banks do to the economy, the more “need” there is for new regulations. But rather than address the problems of large banks, regulators tend to repress the ability of smaller banks and financial institutions to make loans to small businesses and households, which concentrates the supply of financial capital into the hands of large banks.

In effect, the federal government issues regulations that oppress small banks, driving them out of business or forcing them to be sold to larger banks. This represents another part of the anti-reform movement. Reform would address the problems caused by large banks with measures like Glass-Steagall, requiring separation by line of business and anti-trust division. Reform would streamline regulations to help small banks, which in many cases are better suited in attitude and location to make loans to small businesses and consumers than large banks. Small banks know their customers better.

As the government lowers interest rates to borrow more money, it depresses the ability of banks to attract capital by offering interest on savings. This drives savings away from the banks to the financial markets, subject to manipulation or used to purchase financial junk. It also hurts the elderly who, not wanting to risk principal, rely heavily on interest from savings. The government reaps a side benefit. By making it difficult for families to save for their children’s education, the government can charge students higher interest to finance their education than it pays for borrowing money.

Illustrating the problems found with large commercial or investment banks, in October 2013 JPMorgan Chase and the U.S. Department of Justice reached a tentative $13 billion settlement over the bank’s questionable lending practices leading up to the 2008 financial crisis (NYT 2013b). The record penalty would resolve an array of investigations into the bank’s sale of troubled mortgage investments comprised of securities, typically backed by subprime home loans at the heart of the U.S. financial crisis. However, some felt the federal government essentially forced JPMorgan and other banks to offer loans to unqualified home buyers.
While the agreement represented a reckoning for Wall Street whose outsized risk taking in the mortgage business nearly toppled the economy in 2008, civil cases would be put to rest, although the public suffered billions in losses from buying bad mortgage securities. The bank also faced federal scrutiny over a $6 billion trading loss in London in 2012 attributed to its hiring of well connected employees in China.

Howard Davies (2013) noted the agreement with JPMorgan included a payment of $4 billion to settle claims that it misled the government sponsored mortgage agencies Fannie Mae and Freddie Mac about the quality of billions of dollars of low grade mortgages that it sold them. He added how the settlement re-opened the debate about what to do with banks “too big to fail.”

As part of this debate, U.S. policymakers added the Volcker rule (named after Federal Reserve Chairman Paul Volcker) in the Dodd-Frank Act to restrict proprietary trading by commercial banks rather than revive the Glass -Steagall Act’s division of the banking industry into investment and retail banks. But the question remains of what to do about the huge, complex, and seemingly hard to control universal banks that benefit from implicit state support.

Internationally, the problem of huge universal banks was addressed in proposals, agreed to by the Financial Stability Board in Switzerland for the “school solution” where regulators identify significant banks, and impose tougher regulations with intensive supervision and high capital ratios. Initially, 29 banks and few insurers were so designated. Banks on the list must keep higher reserves and maintain more liquidity, reflecting their status as important institutions.

The “old school solution” would recognize banks have a natural incentive in making good loans. Their self interest, not government regulations or bailouts, should govern their risk management. This suggested that large banks need to be restructured.

Davies noted in Britain, the Vickers Commission proposed that universal banks set up retail banking subsidiaries with a much higher share of equity capital. The European Commission came to a similar conclusion about the dangers of combining retail and investment banking, and recommended separating the two. The European Banking Federation described the recommendations as “completely unnecessary.”

But banks need to be separated in major business lines to let them focus on making loans. Otherwise, the excessive concentration of capital may let them redefine their business to manipulate financial markets, rather than making loans.

U.S. Attorney General Eric Holder said, “JPMorgan was not the only financial institution during this period to knowingly bundle toxic loans and sell them to unsuspecting investors.” The Justice Department said JPMorgan bundled low quality loans, re-graded them with better marks to make them attractive to buyers, and sold them without informing the buyers of the risk involved (Yost and Gordon 2013).

In other words, reform would restrict banks from selling mortgage backed securities to investors. The normal activity of banks is to make mortgages and service them. Blocks of mortgages may change hands between banks. Sound practice would keep them within the industry. A bank dumps mortgages because they are unprofitable to service, or perceives an opportunity to turn a quick dollar.

A related area of reform involved aggressive lending practices. Various banks and lending institutions made loans to home buyers with inadequate income and a low down payment, sometimes in areas of the country with rapidly appreciating home values that became asset bubbles. Second mortgages or other loans were also made to cover for down payments.

But mortgage backed securities have a place. Sold in limited programs to private investors, they represent a low cost alternative to construction loans issued by a bank, an investment similar to direct placement bonds.

In August 2013, the Albuquerque Journal noted that new regulations on home mortgages had increased paperwork and closing costs, without necessarily reducing risks. As these regulations increased the cost of new homes and reduced new home construction, they contributed to a stagnant housing industry and weak economy.

In September some experts, including FDIC Vice Chairman Thomas M. Hoenig, expected that regulatory costs and competitive pressures will drive as many as half of the nation’s small banks out of business over the next several years (Quigley 2013). Federal Reserve Bank President Esther L. George of Kansas City said, “Small banks have had to take on costs that came to them from another part of the industry.” She added,
“The regulatory reform we got was largely a reaction to practices of the large banks.”

According to Hal Bailey, New Mexico division manager of Washington Federal, banks had to divert more resources than ever “to answering questions and being in compliance with the new laws.” He added that “it’s hard for small institutions to exist independently because they have to hire the expertise to be in compliance and to deal with regulators.” Washington Federal with $14 billion in assets and other smaller banks have to comply with many of the same regulations as Bank of America with $1.4 trillion in assets.

George noted recent research suggests the largest banks are effectively subsidized by perhaps as much as $80 billion. Credit rating agencies, customers and investors assume that the government will bail them out if they get in trouble, and they receive access to cheaper capital and better loan rates than small banks.

George often hears from smaller banks in the Kansas City Federal Reserve region who complain about losing deals to bigger competitors unable to match loan terms and rates. She added that the nation needs small banks, saying, “History shows losses generally are lower in small banks” because they have “a line of sight to the borrower.” Smaller banks “tend to work more closely with the borrower,” and are more inclined to lend to smaller businesses. The nation’s economy runs on small, medium, and large size businesses, requiring small as well as large banks.

The Albuquerque Journal also carried a series of articles about a local bank, popular and well run, which the new banking regulations cutback and forced its sale. Late in 2013 it reported on the lack of venture capital in New Mexico.

Earlier in 2013 (Douglas) it was reported how banks used billions from a small business lending program to repay government bailout funds instead of making loans to small businesses. The Small Business Lending Fund gave out more than $4 billion to 332 community banks, credit unions, and community development institutions to lend to small businesses.

The fund was especially appealing to small banks that received funds from the Troubled Assets Relief Program (TARP), the federal government’s rescue initiative. By signing up for the new lending program, banks could convert TARP obligations into a lower interest loan and escape restrictions on executive compensation as they increased lending to small businesses. Instead, 132 TARP recipients participating in the new lending program used about $2.1 billion to exit TARP rather than increase their lending to small businesses. According to the TARP special inspector general, 24 of those banks used $501 million without boosting their lending, while the remaining banks increased lending by $1.13 for each $1 of funding they received. Banks in the program that did not participate in TARP lent $3.45 for every $1 they received. Treasury officials and banking regulators claimed that the other party was responsible.

In other words, giving banks liquidity does not result in more lending, especially to small businesses. Raising reserve ratios for banks that were operating well did not help them in making new loans to businesses and consumers. The new banking regulations were oppressing small banks and the economy.

U.S. UNEMPLOYMENT

In July, business analyst Moira Herbst (2013) noted the U.S. economy was still sputtering more than five years after the great recession hit in 2008. The government just revised its GDP growth figures to a meager 1.8 percent for the first quarter of 2013. One reason for the sputtering economy was low demand. Many consumers were not earning enough to pay for healthcare, education, retirement, and other goods and services.

She noted the United States had been wiping out well paying jobs with benefits and replacing them with low paying jobs, which often lack benefits, to its detriment. This hollowing out of its middle class partly reflected a decline in the U.S. manufacturing sector, and shift toward lower paying jobs in the service industry and retail.

Herbst noted the culprit in this weak demand was not just the bursting of the housing bubble in 2008. Wages had stagnated or declined. From 2009 to 2012 real median wages had fallen about 2.8 percent, although productivity increased 4.5 percent.

She added that corporate profits as a percentage of GDP were at an all time high, and big companies were hoarding cash, not using their profits and cash for investment, pay raises, or dividends. This lack of corporate investment could partly be attributed to the
bleak economic outlook, which included new government healthcare and employment regulations, and higher taxes.

Herbst added the unemployment rate of 7.6 percent understated actual unemployment. Buried in the monthly jobs report was the U-6 figure. It included the unemployed as well those "marginally attached" to the workforce who gave up looking for a job and part time workers who want full time jobs. For June 2013 the U-6 figure was 14.3 percent, nearly double the official unemployment rate. Unemployment for youth was higher. Workforce participation decreased. In June 2013 the workforce ratio was 58.7 percent compared to 63 percent five years ago while more workers work part time, more than 8.2 million, almost double compared to five years ago.

In August, economist Martin Feldstein (2013a) noted the current U.S. unemployment rate of 7.6 percent excluded a large number of people who stopped looking for work and were no longer counted as unemployed. Official U.S. figures understate unemployment and the tendency of firms to hire part time workers, a form of underemployment. Still, by January 2014 the unemployment rate had dropped to 6.6 percent, a five year low (U.S. Bureau of Labor Statistics).

Various factors contribute to high unemployment. Some factors are personal. Other factors include the economic expectations that lead businesses to hire employees. Where a growing economy and positive outlook tend to breed investment and hiring, a stagnant economy and uncertain outlook tend to breed low investment and high unemployment unless measures are taken such as a stimulus.

However, skill is needed in applying a stimulus, or it may encumber a country with debt. For example, China’s stimulus that it introduced after the onset of the global recession in 2008 led to excessive investment in its heavy industry and real estate and transportation sectors, which are now causing repayment problems.

A little arithmetic may suggest that the U.S. stimulus did little to create new jobs. Using a figure of a trillion dollars, a significant fraction of its stimulus or new debt, divided by a salary of a hundred thousand dollars a year, would suggest the creation of ten million new jobs. While a stimulus actually works by using an increase in demand to jump start the economy, the question remained of why the U.S. stimulus apparently did so little to create new jobs.

Was the stimulus administered using “clean hands?” Was its increase in demand enough to stimulate the production of goods and services and investment instead of imports? Did it address federal budget deficits to build confidence in the future? The decline in wages from the hollowing out of the manufacturing sector and large bank problems suggested that a path of reform was needed as much as a monetary stimulus.

Herbst believes the United States is living in a zero sum economy, where a handful of investors and owners win at the expense of everyone else. But with new technology, investment, and experience, productivity and income should increase, making the economy a positive factor. But issues remained.

In October it was reported the U.S. recovery was unusually slow (Sullivan 2013). While total output was higher than before the recession, private investment remained lower than in 2007. Employers continued to hire workers at a slow pace. Since the immediate crisis eased, Washington sent one jolt after another. In 2010, Democrats passed sweeping reforms to the healthcare system and financial sector, which, whatever their merit, imposed wrenching changes on the economy.

In other words, the government was acting as a drag on the economy. Increasing tax rates, it was reducing economic growth by reducing private investment and spending, and its “reforms” to the healthcare and financial sector were imposing a regulatory drag on businesses and private investment.

QUANTITATIVE EASING

Introduced under the Obama administration, Quantitative Easing picked up from where the preceding Bush administration left off from its attempt to deal with the financial crisis of 2008. As part of the anti-reform movement, the Bush administration argued that large banks and other financial institutions at the heart of the crisis formed a critical part of the country’s financial infrastructure, requiring their subsidization rather than reform and restructuring.

The government had placed companies “too big to fail,” which evolved into financial dinosaurs, on a financial endangered species list. However the management of financial companies is not so difficult unless upper management decides to engage in questionable activities or excessive risk taking, or federal policies skew their activity in those directions.
Taking action late in the day, the Bush administration decided to subsidize these financial dinosaurs when economic theory suggested these companies needed to be restructured into smaller, more compact businesses, to discipline their management and provide bona fide goods and services.

According to Doug Noland (2013a), a financial manager, Quantitative Easing was introduced after the United States underwent asset bubbles and resource misallocations for about two decades. Easy money and credit policies, along with de-industrialization and a growing national debt, had resulted in a stagnant economy and inequitable distribution of wealth.

Noland described Quantitative Easing as a type of monetary inflation associated with asset inflation, bubbles, and speculation in the financial markets, different from consumer price inflation. Under Quantitative Easing, the Federal Reserve’s balance sheet expanded from less than a trillion dollars to almost $4 trillion. Officials suggested this expansion had a modest impact, although forcing long term interest rates lower. They seemed to believe that as long as Quantitative Easing money sits “idly” on the banking system’s balance sheet as “reserves,” it has a minimal effect on inflation, although the Federal Reserve “pumped” money into the securities markets, a potential cause of asset inflation.

There were three rounds of Quantitative Easing. In the first round, QE1, the Federal Reserve’s balance sheet expanded from about $900 billion in September 2008 to almost $2.3 trillion at the end of 2008, mainly to reduce risk and leveraging within key financial markets. Rather than release the $1.4 trillion of liquidity directly into the real economy or financial markets, QE1 accommodated the transfer of bonds and securities from highly leveraged players in the private market, consisting of Wall Street firms, hedge funds, Real Estate Investment Trusts, and the like, to the Federal Reserve, to stem a collapse of major financial institutions and the global derivatives marketplace. According to Noland, it stopped what would have been a painful but helpful sorting out of speculation from the financial markets. It kept financial companies from facing the consequences of the risks that they had assumed.

In the second round, QE2, the Federal Reserve’s balance sheet expanded from $2.3 trillion in October 2010 to $2.9 trillion by June 2011. Its impact extended into 2012 with the purchase of another $400 billion in long term Treasury securities that were associated with “Operation Twist” where the Federal Reserve sold T-bills and purchased bonds. After trading as high as 3.6 percent in early 2011, 10 year Treasury yields sank to 1.45 percent in May 2012 while benchmark mortgage backed securities yields dropped from 4.40 percent to as low as 1.82 percent, which caused a spike in prices. Government, mortgage, corporate, and municipal bond yields collapsed as hundreds of billions of dollars flooded into fixed income funds and instruments.

QE2 was also instrumental in prompting a surge of destabilizing late cycle “hot money” flows into emerging market economies. International reserve assets, which are indicative of emerging market inflows, jumped from about $8.6 trillion in October 2010 to almost $10.5 trillion by June 2012.

Later in the summer of 2012 the Federal Reserve began talking of an open ended round of Quantitative Easing (QE3) in response to a stubbornly high U.S. unemployment rate. Noland and other analysts believed it was to support a fragile global financial system. At the start of 2013, the Federal Reserve’s balance sheet stood at about $2.9 trillion. By the end of 2013, it was nearly a trillion dollars higher, making QE3 one of the largest direct injections of liquidity from a central bank into the financial markets.

With these large injections of liquidity, Noland noted the prevailing inflationary bias in 2013 shifted to equities. As the Federal Reserve purchased U.S. Treasuries, liquidity was transferred to exiting investors who then invested in the Total Stock Market Index Fund, bidding up prices. Or, a central bank sold U.S. Treasuries to the Federal Reserve, which used its liquidity to purchase currency from a hedge fund that put its money into equities. Toward the end of 2013, one analysis suggested Quantitative Easing contributed to a 40 percent surge in the broad U.S. stock market.

While some Federal Reserve officials saw the need to rein in the growth of its balance sheet assets, Noland noted its policy was apparently tied to support for the ongoing fiscal and monetary policies of Washington, including a buyer of government debt.

Economist Allan Meltzer (2013) noted how until now, almost all recoveries from recessions had rapid growth in employment. Now as central banks in advanced countries such as the United States pursue expansionary monetary policies to boost their demand...
in the wake of the global economic crisis, the creation of new jobs lagged and workers left the workforce in droves.

Meltzer noted the Federal Reserve reduced interest rates to unprecedented levels, and used Quantitative Easing to buy assets to augment bank reserves. Inflation, which the rapid expansion of the money supply inevitably fuels, stayed low at about 2 percent as banks did not use their swelling reserves to make loans. While this kept inflation in check, it hindered the growth of employment.

Rather than change its approach, the Federal Reserve responded to the slow growth in employment with more Quantitative Easing. Its rationale was if expanding its reserves by more than $2 trillion did not produce the desired result, adding another $85 billion a month more, about $1 trillion annually, might increase job growth. But the growth in reserves was not creating employment since they were not used in making loans to increase demand and investment.

In other words, Quantitative Easing was not working. During QE2 from November 2010 to July 2011 the Federal Reserve added $557.9 billion to reserves as excess reserves grew by $546.5 billion. Banks circulated only 2 percent of QE2 into the economy, leaving the rest idle. Since QE3 was launched in September 2012, total bank reserves grew by $244.1 billion while excess reserves grew by $239.4 billion, meaning 99 percent of the funds were idle. Since banks earn 0.25 percent interest on their reserve accounts, but pay lower interest rates to depositors, they left the money idle, drawing interest from it risk free rather than making new loans to businesses, especially small businesses.

Meltzer noted how at current interest rates, banks lend to the government, large, stable corporations, and commercial real estate dealers. They do not extend credit to riskier borrowers, to those with good but unproven projects, start up companies, or first home buyers. As a result, while speculators and bankers profited from the decline in interest rates that accompanied the Federal Reserve’s massive purchases of assets, the intended stimulus to investment and employment was absent.

According to Meltzer, the stimulus was misapplied. Federal Reserve policies seemed to suppress growth and employment. Quantitative Easing did not result in a large expansion of the money supply with the tendency of banks to create excess reserves and minimize loans to new and small businesses. The economy did not respond to its monetary expansion with investment and employment.

One problem was insufficient investment. President Obama’s effort to increase income taxes on people whose annual income exceeds $250,000 reduced their ability to invest, as did his cap on retirement benefits. As long as sources of new tax revenue and regulations remained uncertain, those whom such policies would harm financially, the country’s largest savers, were unlikely to invest.

Likewise, President Obama’s healthcare reform, the Affordable Care Act, hampered employment as businesses sought to reduce hiring and cut the hours of workers to shelter themselves from higher health insurance premiums. A faltering European economy and the slowdown in China’s economy and in other countries impeded U.S. exports. While subdued liquidity and credit growth were delaying the inflationary impact of the Federal Reserve’s massive expansion of reserves at large banks, Meltzer believes the United States cannot escape inflation forever, at a higher rate than currently.

In July, economist Martin Feldstein (2013b) offered an explanation for the question, “Why has the Federal Reserve’s printing of so much money not caused higher inflation?”

Feldstein started by noting how inflation in the United States has been low. Over the past five years, the consumer price index increased at an annual rate of just 1.5 percent and the Federal Reserve’s preferred measure of inflation, a price index for personal consumption expenditures, excluding food and energy, also rose at an annual rate of just 1.5 percent.

In contrast, during this period the Federal Reserve’s purchases of long-term bonds increased to an unprecedented level. It purchased more than $2 trillion of U.S. Treasury bonds and mortgage backed securities, nearly 10 times its annual rate of bond purchases during the previous decade.

Feldstein noted how history shows that rapid monetary growth fuels inflation. That was clear from Germany’s hyperinflation in the 1920’s, and Latin America’s high inflation in the 1980’s. In recent years, moderate growth in the U.S. money supply translated into more inflation. In the 1970’s the U.S. money supply grew at an average annual rate of 9.6 percent while
inflation averaged 7.4 percent. In the 1990’s the U.S. money supply grew at an average annual rate of 3.9 percent while inflation averaged 2.9 percent.

The relative absence of inflation with the Federal Reserve’s massive purchases of bonds in the past five years, which appeared to increase the supply of money, seems puzzling, until it is realized that Quantitative Easing was not the same thing as “printing money.” or, more accurately, increasing the stock of money.

Feldstein noted how the measure of money stock that relates most closely to inflation consists primarily of the deposits businesses and households hold at commercial banks. Where bond buying by the Federal Reserve has usually led to a faster growth of this stock of money, in 2008 the Federal Reserve changed its rules, breaking the link between its purchases of bonds and resulting growth in money supply. As a result of the change, the Federal Reserve was able to buy massive amounts of government bonds without causing the money supply and rate of inflation to rise.

The link between bond purchases and stock of money depends on the role of commercial banks' “excess reserves.” When the Federal Reserve buys Treasury bonds or other assets like mortgage backed securities, it creates “reserves” for commercial banks, which the banks deposit at the Federal Reserve itself. They are required to hold reserves equal to a share of their checkable deposits. Since reserves in excess of the required amount did not earn any interest from the Federal Reserve before 2008, banks had an incentive to lend to households and businesses until their growth of deposits used up their excess reserves. Increases in these deposits at commercial banks were, by definition, an increase in the stock of money.

An increase in bank loans allows households and businesses to increase their spending. That extra spending means a higher level of nominal GDP. Some of the increase in GDP takes the form of higher real GDP, while the rest is inflation. That is how Federal Reserve purchases of bonds historically increased the stock of money and rate of inflation.

After 2008 the link between Federal Reserve bond purchases and subsequent growth of the money supply changed because the Federal Reserve began to pay interest on “excess reserves.” The interest rate on these totally safe and liquid deposits induced commercial banks to maintain their excess reserves at the Federal Reserve instead of making more loans, and creating deposits to absorb the increased reserves as they would have before. As a result, the volume of excess reserves held by the Federal Reserve increased dramatically from less than $2 billion in 2008 to currently $1.8 trillion.

The new Federal Reserve policy of paying interest on excess reserves meant that after 2008, the increase in excess reserves did not lead to a much faster growth in deposits and money stock. From the end of 2008 to the end of 2012 the M2 measure of broad money stock grew an average of just 6.2 percent a year. While nominal GDP generally rises over long periods of time at the same rate as the money stock, with interest rates so low after 2008, households and institutions were willing to hold more money. So while M2 grew by more than 6 percent, normal GDP grew just 3.5 percent and the GDP price index rose by only 1.7 percent. So it is not surprising inflation remained moderate. It is also not surprising Quantitative Easing did so little to increase real economic activity.

The absence of significant inflation in the past few years does not mean it will not arise in the future. When businesses and households eventually increase their demand for loans, commercial banks with adequate capital may decide to meet that demand with new loans. The resulting growth in spending by businesses and households might be welcome at first, but could become a source of unwanted inflation.

In principle, the Federal Reserve could limit inflationary lending by raising the interest rate on excess reserves or using open market operations to increase the short-term federal funds interest rate. But it might hesitate to act, or act with insufficient force, owing to its dual mandate to focus on employment as well as price stability, a likely outcome if high unemployment persists as inflation rises. Some investors were concerned that with its massive bond purchases, inflation could return. The Federal Reserve might become reluctant to raise interest rates since it would increase the interest that the federal government pays to service its debt.

Regarding inflation, European economist Brigitte Granville (2013) observed how with all the problems afflicting the global economy, inflation seemed to be the least of its worries. Addressing the post 2008 economic malaise, she felt policymakers were correct to focus on the threat of debt deflation, which could lead to depression. But dismissing inflation as “yesterday’s problem” could facilitate its resurgence.
Granville believes that understanding how the Great Inflation from the late 1960’s to the early 1980’s was tamed offers important lessons for addressing the problems that may lie ahead with the rapid accumulation of large amounts of debt unrelated to investment that is likely to require servicing without a more productive economy. One lesson is how inflation is generated by inflationary expectations.

She related how after World War II, the doctrine that inflation could trade for employment, based on the relationship William Phillips described in 1958, and became known as the Phillips curve, dominated economic thinking. But the Phillips curve fared poorly during the 1970’s when many countries experienced “stagflation,” consisting of both high levels of inflation and unemployment. In effect, higher inflation does not necessarily trade for low unemployment.

This “stagflation” vindicated criticism by Milton Friedman, Edmund Phelps, and others, who argued that the Phillips curve represented a short term relationship. If people do not expect inflation, the illusion of increased purchasing power can boost employment and output. But once workers realize real wages have not increased, unemployment will return to its “natural” level, consistent with stable inflation.

Later, “new classical” economists like Robert Lucas and Thomas Sargent demonstrated that once people understand inflation is being manipulated to generate market optimism, the actions of monetary authorities or central banks lose their impact. The result is higher prices and no job creation. These ideas, combined with effective practices like that of the U.S. Federal Reserve under the chairmanship of Paul Volcker, enabled many countries to stabilize inflation by making a credible commitment to a predetermined rate of increase in the rate of inflation. By the 1990’s, inflation was old news, at least in most developed economies.

Granville noted how today, the Federal Reserve is again playing the expectations game. To stave off the threat of deflation and depression, it targeted an unemployment rate of below 6.5 percent, which, before the global recession, would have been considered high. As progress was made in the recovery, in May 2013 Federal Reserve Chairman Ben Bernanke announced that the Federal Reserve will begin to “taper” its Quantitative Easing program of long term asset purchases. The prospect of “tapering” sparked volatility in the financial markets. To calm investors, in July, the Federal Reserve signaled it would not soon abandon its stimulus.

This stance reflected the Federal Reserve’s dual mandate, where monetary policy targets maximum employment consistent with price stability. However, the credibility needed to anchor inflationary expectations is difficult, and may be impossible to achieve when two targets are pursued at the same time. Uncertain monetary policy may trigger volatility, especially in the bond markets. It may impede recovery by pushing up long term mortgage rates and raising expectations of future inflation.

By contrast, pursuing only an inflation target, a simpler, more realistic goal, builds credibility. It may be safer and more effective for the Federal Reserve and other central banks to pursue an inflation target, and use their gain in credibility to aid the recovery. For example, a central bank might announce over the next two years it plans to double the inflation target from the usual annual rate of 2 percent to reduce the risk of debt deflation, and cap inflation expectations as recovery takes hold.

Granville noted how such preventive measures are all the more important in view of the second lesson of taming the Great Inflation, that fiscal discipline is essential to price stability. Sustaining high budget deficits for many years will lead to an unmanageable buildup of debt unless that debt is inflated away or restructured.

In late 2013 the United States planned to taper Quantitative Easing when the economy grows faster, unemployment is lower, and government and household revenues are rising. But will tax revenue rise fast enough to offset the escalating cost of servicing its growing mountain of debt? Even if its debt does not grow as fast as before, its existing debt must be serviced. The best cure would be controlled inflation or the previously mentioned temporary increase in the inflation target, to erode the real value of public debt and forestall the risk of a more damaging inflation later on.

While this approach could work in the United States, the European Central Bank is constrained from raising the inflation target. Its pledge in 2012 to purchase unlimited quantities of short term government debt calmed markets, but its “outright monetary transactions” program is conditional on fiscal retrenchment that will stop the crisis stricken economies in the eurozone (countries in Europe that use the euro for their currency) from growing.
In this context, Granville noted the eurozone’s most heavily indebted countries will have to force their creditors to accept a restructuration of debt. The preferable alternative would be currency devaluation, a breakup of the eurozone. Strong economies continue to use the euro while weaker economies introduce a devalued currency. But if devaluations are delayed too long, debt restructuring may be needed. In the coming years, Europe may lurch from depression to high inflation. When it does, the lessons of taming the Great Inflation will suddenly become pertinent.

**TAPERING AND STIMULUS**

In September, Stewart (2013) observed that Federal Reserve Chairman Ben Bernanke was expected to announce a tapering of its government bond purchases. Many analysts believed the tapering would be symbolic, a reduction of $10 billion to $15 billion in the Federal Reserve’s $85 billion monthly purchases of U.S. Treasury bonds and mortgage backed securities. Tapering would represent a vote of confidence in the U.S. economy that appeared to reach a turnaround in its housing market and creation of new jobs.

However, the Bank of International Settlements warned the withdrawal of cheap money from the economy might do more harm than good. Tapering posed risks. It could cause investors to dump bonds, forcing interest rates up and choking off the recovery. It risked bursting the commodities bubble built up from the growth in the Chinese economy with its heavy emphasis on construction. Some of the billions of dollars poured into Wall Street had found their way into commodities speculation.

Another risk was inflation. While the Federal Reserve can quickly raise interest rates to catch up to inflation, selling assets to absorb cheap money out of the economy cannot be done overnight. Bankers were worried about price deflation from overheated markets and asset bubbles. If interest rates increase, the Federal Reserve would have large paper losses on its bonds, and the federal government would need to spend more on interest payments to service its debt.

Later in September, the Federal Reserve decided against tapering (Taipei Times 2013e), wanting signs of a stronger recovery, and concerned by the disagreement on raising the debt ceiling between President Obama and Congress. While there was euphoria in the financial markets over its decision to keep buying bonds, the question remained of how much longer it would keep up its purchases.

Finally, in December (Puzzanghera 2013), the Federal Reserve announced it would taper its monthly bond purchases by $10 billion. Starting in January 2014, it planned to reduce its purchases of mortgage backed securities from $40 billion to $35 billion and reduce its purchases of Treasury securities from $45 billion to $40 billion. The decision to taper reflected a drop in the unemployment rate to below 7 percent in November. To boost growth, it promised to keep short term interest rates low.

In January, Feldstein (2014) expressed optimism for the U.S. recovery. As background, late in the summer of 2007 he warned of serious risks to the economy from the fall in housing prices that began in the summer of 2006, and later caused a collapse in the home construction industry and large losses in household wealth, which led to lower consumer spending, further depressing GDP. Feldstein stressed that the financial markets had become dysfunctional. Banks and other financial institutions had doubts about the value of their asset backed securities, and no one knew the real value of their credit default swaps. As financial institutions became reluctant to lend to each other, the economy could not expand with credit flows disrupted.

Feldstein also warned the Federal Reserve had become complacent, and was not reducing the federal funds rate fast enough, then above 5 percent. After the economy peaked a few months later, in 2008 the Federal Reserve began to ease credit, but not enough to restore solid growth. Normalcy in the financial markets and lower interest rates caused an upturn in the summer of 2009, but growth was weaker than expected. Unlike previous business cycles, the recession that began at the end of 2007 was not caused by high interest rates, so lowering interest rates had little impact.

While newly elected President Barack Obama and his administration announced a three year fiscal package to stimulate aggregate demand, Feldstein noted that the package was ineffective, too small to close the output gap, leaving a downward pressure on demand. Moreover, much of the “stimulus” package went to financing state government spending that would have been paid for in other ways and increased transfer payments that added more to debt than GDP. When the Federal Reserve saw how weak the upturn was, it began its “unconventional monetary policy” that combined large scale purchases of long term securities
with promises to keep short term federal interest rates extremely low for an extended period of time.

Feldstein noted the goal was to encourage portfolio investors to shift into equities and other assets. The resulting increase in their prices would push up household wealth and consumer spending as lower long term interest rates reduced the cost of mortgages and raised the value of homes. But the Federal Reserve and others were overly optimistic about the effectiveness of their goals in boosting GDP.

From another perspective, the Obama administration needed to encourage domestic manufacturing instead of increased imports from China, and encourage investment rather than discourage lending with its new banking regulations. It also needed to safeguard its green energy initiative from Chinese companies who wanted to exploit the U.S. market and technology. The Federal Reserve sought to assist the stimulus by its "unconventional monetary policy," but its plan to inflate asset values to increase consumer spending was indirect, more helpful to the financial markets and money class than directly increasing the production of goods and services.

Feldstein also observed that despite the fall in long term interest rates for mortgages, housing prices reached bottom only in 2012, and the stock market did not rise faster than corporate earnings until 2013. The U.S. economy limped along. Real GDP in the final quarter of each year was less than 2 percent higher than the previous year. Employment grew more slowly than population, and increases in real wages averaged only about 1 percent.

For 2014 the outlook appeared to improve as real GDP growth reached 4.1 percent in the third quarter of 2013. Fourth quarter growth appeared strong with a rise in housing starts and industrial production. Sharp increases in housing prices and equities contributed to a rise of roughly $6 trillion in real household wealth in the 12 months ending in September 2013, indicating a potential increase in consumer spending.

But there were risks since nearly half of 2013’s third quarter GDP growth was from inventory accumulation. Businesses worried about higher corporate taxes, especially if the Republican Party loses its majority in the House of Representatives. While deficits were temporarily down, an aging population and higher interest rates in the future are likely to cause the national debt to rise faster than GDP. Still, the prospects for the economy appeared better than any time since the downturn began in 2008.

With improved prospects for the U.S. economy, in January 2014 the Federal Reserve announced it planned to end Quantitative Easing (Crutsinger 2014), making reductions in its monthly purchases of bonds and mortgage securities, while it restated its intent to keep short term interest rates at low levels for an extended period of time.

MONEY EXPLANATION

Noland (2013b) observed how credit in the United States changed in the 1990’s with the proliferation of market based credit, including government backed mortgage securities, derivatives, hedge funds, and “Wall Street Finance,” forming an unstable base of credit compared to the credit traditionally obtained from banks. In 1994 and 1995 the bursting of a speculative bubble in bonds, mortgage backed securities, and derivatives, which government bailouts and interventions accommodated, left behind unresolved issues.

Monetary policy changed to meet the demands of the new credit. Under Chairman Alan Greenspan, the Federal Reserve adopted a limited approach to rein in speculative bubbles using a strategy of “pegging” short term interest rates. This helped stabilize the markets, but resulted in an expansion of credit, financial leveraging, and speculation, which the Federal Reserve accommodated.

This credit expansion reflected a change in the U.S. economy, a shift to a service and consumption based economy as trade and federal budget deficits seemed never ending. The Federal Reserve pushed interest rates down, talked of a “government printing press” to spur credit growth after the “technology” bubble burst, and increased its balance sheet with the monetization of government debt and mortgage backed securities. Marketable debt re-inflated. After the recession hit in 2008, the Federal Reserve started its $85 billion monthly purchases.

Noland (2013c) noted how with Quantitative Easing, the Federal Reserve was building the expectation that it will continue to mop up after asset bubbles burst. Arthur Grimes, who developed inflation targeting at the Reserve Bank of New Zealand in the 1980’s, said that this policy made asset bubbles more likely, and warned Federal Reserve officials to be consistent in setting
their future guidance on interest rates to keep their credibility and not disguise changes in their inflation goals, a major factor in fighting consumer price inflation.

Noland and some analysts saw the policies of Federal Reserve Chairman Ben Bernanke as instrumental in creating the bubble that collapsed in 2008. He seemed to champion a view that central banks should ignore asset bubbles, and rely instead on regulation to contain excesses, while central banks mop up or re-inflate values. His policy seemed uncomfortably close to the stock market crash of 1929. Then an extreme upward push on the stock market that was unsustainable resulted in its crash and run on banks. Too much of the country’s capital was concentrated on Wall Street and highly leveraged. The government was ineffective at regulating Wall Street just as it was ineffective at remedying the subsequent run on banks.

Bernanke doctrine held that debt problems can be inflated away through aggressive monetary expansion. Under his tenure, the Federal Reserve targeted mortgage credit for re-inflation. Using government credit to re-inflate the mortgage finance bubble, it began to support speculative asset bubbles, with their redistribution of wealth.

Noland noted that those on the political left pressed for wealth redistribution using higher income tax rates and more entitlements, without addressing Federal Reserve policy or the need to make capital available for real investment. “Printing money” to cover federal deficits and mop up asset bubbles makes it difficult to have a balanced economy with real growth. Monetary inflation targets higher asset prices not real investment, when real investment is important since it supplies good jobs, which is what most people want.

Another issue was the federal deficit. As its deficit eats into income, it depletes capital, unless created by the government in a stimulus, which, in the United States, was poorly designed to create new jobs.

Regarding Federal Reserve plans to increase GDP with more credit, Noland noted that households seemed to have little appetite for adding to their huge debt load partly due to the high interest rates often charged for credit cards, and corporations were sitting on large cash balances. This indicated that the federal government needed to change its policies to support investment rather than more credit and liquidity.

**STRUCTURAL ISSUES**

Structural issues were hampering the U.S. recovery. New banking regulations were oppressing the operation of smaller banks and financial institutions, which reduced the availability of loans to small businesses, start ups, consumers, and for home mortgages. Banking regulations were concentrating financial capital into the hands of large banks where reform was needed, but had been rejected with the repeal of proven reform measures such as Glass-Steagall.

Reform seemed to be rejected in the sale of mortgage backed securities, which would require the acceptance of risk by the financial markets, not the government, and prohibit the sale of securities that seem to break the normal relationship between a borrower and lender. New regulations that added paperwork to already lengthy home closings were effectively oppressing the economy.

The use of Quantitative Easing to prop up the financial markets, which was only weakly related to the creation of new jobs, illustrated how monetary expansion and high liquidity do not substitute for real investment, or funding for research and development.

The federal government needs to rein in its deficit spending. While popular, current entitlement programs are unsustainable. Businesses need an honest effort to balance the federal budget, not just predictions of growth, to generate confidence in their planning and investment, and government deficits were apparently reducing the availability of capital to businesses and consumers.

Noland (2013d) noted Washington had shown little fiscal discipline as the federal debt more than doubled in five years, while issued at record low market yields. Some analysts believed the deficit spending was justified as a stimulus, but a stimulus should result in economic growth.

Boskin (2013) observed that a hot topic in economic theory is how large declines in economic growth are associated with public debt to GDP ratios of over 90 percent. The observation is contentious because of the politically charged atmosphere where various special interest groups want to sustain high government spending without accounting for its sometimes lack of effectiveness in stimulating growth, or how the historical record shows that high debt levels are economically risky.
He noted that while large deficits can be benign or helpful in a recession, war, or financing public investments, they tend to crowd out private investment, savings, and foreign capital with the effect of reducing economic growth. In a deep recession, central bank policy of low long-term interest rates can, in principle, be helpful. But the political process may spend ineffectively, with poorly timed or ineffective responses focused on income transfers rather than purchases that stimulate demand, and marginal tax rebates and spending that does little good in the short run and lasting harm in the long run.

He noted the 2008 stimulus barely moved consumption upward, and the 2009 stimulus cost hundreds of thousands of dollars per job, many times higher than median pay, making it highly ineffective at providing jobs, let alone jobs that were productive.

In the United States, the impact of increases in public debt, largely due to the explosive growth of spending on pensions and healthcare was estimated under four different models to reduce the U.S. standard of living by about 20 percent in a generation, unless steps are taken to control the increase in entitlements. Much of this adverse effect is due to the effect of government debt crowding out private capital investment.

Boskin observed how numerous studies show government spending “multipliers” shrink rapidly over time, turn negative, and may even stay negative in an economic expansion. Permanent tax cuts and reductions in marginal tax rates, which move closer toward a flat income tax rate, have been shown to be more likely to increase growth than increases in government spending or temporary marginal tax rebates. Successful fiscal consolidations emphasize spending cuts over tax hikes by a ratio of five or six to one, while tax increases are more likely to cause recessions.

He noted the evidence clearly suggests that high debt to GDP ratios impede long term economic growth, and fiscal consolidations should be phased in gradually as economies recover for the purpose of reducing government spending. The notion that a country or economic zone can wait 10 or 15 years to start dealing with excessive deficits and debt, as suggested by some economists, is irresponsible.

Another structural issue resided in how the government needs to encourage small businesses, start ups, and innovation with a pro-business regulatory environment rather than discourage businesses with a hostile regulatory environment with complex healthcare and taxation regulations.

Other issues may be found in the weakness of U.S. energy policy, which appeared to be less than enthusiastic for the boom in oil drilling, and reluctant to support building an oil pipeline from Canada. Its support appeared to be mild for electric and hybrid vehicles when the country’s transportation system would do well to incorporate those new technologies, in addition to high efficiency gasoline engines.

Finally, Congress and the Obama administration needed to adjust the entire gamut of entitlement programs, beginning with Medicare, Social Security and including the federal retirement system. An aging population and increased longevity were dictating a shift in retirement ages upward to avoid future bankruptcy. A similar process was needed at the state level, where early retirement ages and overly generous benefits were causing funding shortfalls.

CONCLUSION

Different countries have taken different approaches to break out of the global recession that began in 2008. After a change in its leadership late in 2012, Japan employed a fiscal stimulus, low interest rates, and change in its business environment to streamline labor regulations and encourage small businesses, start ups, and innovation. Its efforts appeared to enjoy success.

The Philippines increased its economic growth rate using a clean hands campaign against corruption, and investment in sound transportation infrastructure of roads and airports. It showed how principles of good governance, letting businesses focus on business, and government focus on sound investment, can increase economic growth.

On the other hand, Taiwan struggled with its economy, having relocated a large part of its manufacturing sector to China. Countries need a better economic growth model than the relocation of manufacturing and capital overseas. But Taiwan also showed how funding research and development is a sound principle for economic success.

Like Taiwan, the United States struggled in its recovery with relatively high levels of unemployment. Part of its weak recovery may be traced to banking problems. First, its new banking regulations were
oppressing small banks and financial institutions, making it more difficult for small businesses, start ups, and consumers to obtain loans. Reform would make capital or loans available to small businesses, start ups, and innovation, as well as consumers and homebuyers.

Second, long before the onset of the 2008 global recession, the United States rejected proven reform measures such as Glass-Steagall and anti-trust actions to separate the very large commercial and investment banks into major lines of business, which became partly responsible for the recession.

Within the United States, there is a divide between business and financial communities, led by the money class. Where business investment treats money as capital, the money class uses it to engage in financial manipulations of markets, only remotely related to providing loans and capital to businesses and consumers.

In addition, reform is needed in the economic structure of large banks and other financial institutions to require that their normal business operations provide adequate incentive to manage risk instead of relying on the government for bailouts and subsidies on the basis of being “too big to fail.” Financial dinosaurs need reform, especially when the business environment calls for their extinction.

In the United States, a good governance drive can take the form of relief from jolt after jolt to businesses from excessive or poorly designed regulations, whether for healthcare or taxation. By minimizing time and expense spent on compliance, the streamlining of regulations can increase income.

Growth can also come from reductions in tax rates. Letting businesses focus on business is more likely to lead to growth than forcing them to focus on regulatory compliance and tax avoidance.

In addition, the U.S. stimulus appeared to fund mainly transfer payments rather than a stimulus to manufacturing and business investment, which could generate new jobs. And the country appears to need better goals and funding for research and development. This included a space program with goals that advance it rather than lose the ability to launch a man into orbit, and build a space station related to the exploration of space.

In a related area, the U.S. production and development of military aircraft and satellites seemed in need of better leadership, seen in cost increases and delays in the production of the F-35 Joint Strike Fighter, or large cost increases and delays in its development of weather and early warning satellites.

While the Obama administration had begun to address the one-sided trade deficit with China, much more could be done. The world needs a better economic growth model than Chinese mercantilism, used by some corporations to take advantage of China’s cheap labor and promote their ties to China’s elite.

Finally, the United States needs to exert proper management over Social Security and Medicare programs, generally adjusting retirement ages upwards to encourage broader workforce participation, and face the changes in demographics that place an unfair tax burden on younger taxpayers.

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