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# High Wages Versus High Savings in a Globalized World

21-27 minutes

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Investment-driven growth can broadly occur in the form of one of two models, each with a different way of treating wages and household income. One model, which I will call the high-wage model, incorporates and encourages high wages as the engine behind growth and productivity gains. I will call the other model the *high-savings* model. In this model, growth seems to be driven mainly by growth in savings, which provides the cheap capital that drives investment, which in turn drives productivity gains.

The classic version of the high-wage model historically is probably the American System that evolved during the early nineteenth century, which was later [formally described](#) by the German economist Friedrich List, who was especially insistent that “*the power of producing wealth is infinitely more important than wealth itself.*” In a [1997 paper](#), Israeli economist David Levi-Faur writes:

*According to List, the real distinction between backward and well-developed economies is based on the quality and quantity of the productive powers. Productive powers—mental capital, natural capital and material capital—are to be found in large quantities in developed economies, whereas they are*

*present to a much lesser extent in backward economies . . .  
Thus, development is perceived as a process of augmentation  
of mental capital.*

In the American System, high wages reward the development of human, or mental, capital while driving growth in consumer demand that itself drives growth in private sector investment.

In the high-savings model, on the other hand, rather than drive growth, high wages are the consequence of growth. The best-known version is the so-called Japanese model, also known as the East Asian development model. This model boosts savings by encouraging wage constraint and other mechanisms that slow growth in household income relative to overall growth. The high-savings model sees higher wages as the ultimate goal, but rather than spur growth, higher wages are a trickle-down consequence of growth.

In other words, both models are designed to boost growth, wages, and investment, but they do so in different ways and create different kinds of domestic imbalances. All rapid growth is unbalanced, of course, and all imbalances must eventually be reversed; but while some versions of the high-savings model seem capable of driving more muscular, higher rates of growth in the short term, it may be that the imbalances are deeper and harder to reverse and the subsequent adjustment process may be more difficult.

### **The Gerschenkron or High-Savings Model**

The Chinese development model is largely based on the Japanese version of the high-savings model, and analysts in China and abroad have long noted similarities between

Chinese growth in the past two decades and Japanese growth in the 1970s and 1980s. This model at least partially describes the recent development not just of Japan and China but also of South Korea, Taiwan, and one or two other East Asian economies, along with Hong Kong and Singapore perhaps, although—the latter two being trading entrepôts—it is not clear to me how relevant they may be.

*Wikipedia* conveniently describes some of the characteristics of this [East Asian model](#):

*Key aspects of the East Asian model include state control of finance, direct support for state-owned enterprises in “strategic sectors” of the economy or the creation of privately owned “national champions”, high dependence on the export market for growth, and a high rate of savings . . .*

*This economic system differs from a centrally planned economy, where the national government would mobilize its own resources to create the needed industries which would themselves end up being state-owned and operated. [The] East Asian model of capitalism refers to the high rate of savings and investments, high educational standards, assiduity and export-oriented policy.*

In several of my earlier essays, I have referred to this model of high-savings, investment-driven growth as the Gerschenkron model because its two main characteristics derive from Alexander Gerschenkron’s description of the main growth challenges faced by developing countries. In a [June 2014 blog entry](#) called “The Four Stages of Chinese Growth,” I set out briefly the main characteristics of the model:

*Like the many previous examples of investment-driven growth*

*miracles, China embarked on a program to resolve the major constraints identified by Alexander Gerschenkron in the 1950s and 1960s as constraining backward economies: a) insufficient savings to fund domestic investment needs, which had to be resolved by policies that constrained consumption growth by constraining household income growth, and b) the widespread failure of the private sector to engage in productive investment, perhaps because of legal uncertainties and their inability to capture many of the externalities associated with these investments, which could be resolved by having the state identify needed investment and controlling and allocating the savings that were generated by resolving the savings constraint.*

The Gerschenkron, or high-savings, model has a fairly long prehistory. Its roots go back at least as far as the combination of infant industry protection, internal improvements, and a system of national finance that emerged from policies designed by Alexander Hamilton and which subsequently made up the so-called American System of the 1820s and 1830s. I am not going to delve too deeply into this part of history, but for those who are interested, in February 2013, I published [a long essay](#) called “China and the History of U.S. Growth Models,” with the requisite references to [the work of Michael Hudson](#); in this essay, I trace the origins of the Chinese development model to the American System.

## **High Savings Versus High Wages**

I would argue that the key difference between the two investment-growth models is their treatment of wages and savings. Gerschenkron argued that investment in developing

countries was typically constrained by low domestic savings. This made developing countries generally both overly reliant on the import of volatile foreign savings and subject to high capital costs. This is why Gerschenkron argued in favor of policies that forced up domestic savings as a way to speed up the development process.

It turns out that the way to [force up savings](#) is to force down the household share of GDP. This explains the high savings accrued not just in China and Japan but also in Germany and other economies with high savings rates and large current account surpluses. Because household consumption is largely a function of household income, this forces down the overall share of consumption in an economy's GDP. Of course, the inverse of a low consumption share is a high savings share, so policies that force down the relative share of household income automatically force up a country's savings rate.

This didn't happen in the United States. [The American System](#) was developed in opposition to the then-dominant economic theories of Adam Smith and David Ricardo, in part because classic British economic theory seemed to imply that reductions in wages were positive for economic growth because they made manufacturing more competitive in international markets.

A main focus of the American System was precisely to explain what policies the United States, which enjoyed much higher wages than Europe, had to engineer so as to generate rapid growth.<sup>1</sup> [In the U.S. model, high wages turned out to be a source of economic strength, not a weakness.](#) In fact, sustaining high wages became one of the key aspects of the

American System; one consequence of this approach was continuous pressure to drive productivity growth through institutional reform and well-aligned entrepreneurial incentives rather than mainly by pouring money into capital investment.

This is not to say that Washington and local governments in the nineteenth century did not play an active role in building and funding American investment: they did. And governments, especially local governments, were a major reason for very high levels of American investment. But their role was mainly to fund infrastructure that supported private sector entrepreneurial activity. In the high-savings model, by contrast, it seems that investment in infrastructure is the driver of growth.

## How to Force Up Savings

When it came to wages, however, the high-savings model, including the Japanese version, shared its view of wages not with the American System, but rather with classic British economic theory. Rather than take steps to force up wages and keep them high—thereby both driving productivity growth and creating a large domestic consumption market for national producers—the high-savings model sought to repress growth in household income relative to total production as a way of subsidizing international competitiveness and forcing up domestic savings. This is perhaps the main reason why the United States, unlike many other countries that implemented similar development strategies in the twentieth century, tended to run large current account deficits for much of the nineteenth century.

In my opinion, this different focus on whether high wages are to be encouraged or discouraged—although discussed very little in the theoretical literature as far as I know—represents the most important difference between the American System and its many investment-driven descendants in the twentieth and twenty-first centuries. I would argue that one consequence is that growth in demand tends to be more sustainable in the former, because it is based on more balanced growth in both consumption and investment. Another consequence is that the inverse of the low household income share of countries following the latter model is a very powerful group with an abnormally high share of income and an unwillingness to allow any reforms that rebalance income.

The point is that this high-savings, investment-driven development model—which, as I said earlier, focuses primarily on forcing up domestic savings and channeling these resources into long-term investment in infrastructure and manufacturing capacity—is actually a relatively old concept that the Japanese version developed in specific ways that were later copied by China and several other East Asian countries. At the risk of vastly overgeneralizing, it seems to me that the key differences in the various forms of this high-savings growth model involve the kinds of policies that explicitly or implicitly forced up the savings rate.

One form of this model was practiced beginning in the 1930s by the Soviet Union, which more or less invented it, although we also see similarities in German economic policies during the same period. I would argue that the mechanism that forced up the savings rates in the Soviet Union and other Warsaw Pact economies seems to have been the scarcity of

consumer goods: income levels among workers were generally not too bad, but these workers could only convert income into consumption with great difficulty, if they got in the right line at the right store early enough. What households could not consume, of course, piled up in the form of savings.

There were other ways of forcing up savings. In some countries, it was significant levels of income inequality and wealth concentration that limited domestic consumption and forced up the savings rate. One example of this process, confusingly, might even be the United States in the 1920s, as Marriner Eccles (the brilliant Federal Reserve chairman under then-president Franklin D. Roosevelt) [explained endlessly](#) to an uncomprehending elite: if all the chips at the poker table are held by the same few players, the only way the rest can keep playing with them is to borrow chips, even though in the end they will not be able to repay the loans.

Countries with significant concentrations of wealth tend to have low consumption rates, as I explained in a [March 2014 blog entry](#). While this boosts growth in countries with very high levels of desired investment constrained by low access to savings, countries whose investment rates are not so constrained can only grow if they export excess savings and run current account surpluses, or if they allow the domestic debt burden (that is to say debt growing faster than debt-servicing capacity) to surge.

Other countries employed high, progressive income tax rates to boost domestic savings, perhaps most obviously Brazil in the 1950s and 1960s. High, progressive tax rates, of course, can reduce disposable household income as a share of total



GDP, thus forcing down consumption and forcing up savings.

Still other mechanisms used to force up savings involved keeping workers' wages low to increase international competitiveness which, of course, also limited consumption growth. Germany's Hartz reforms are the most obvious recent example, and I think Germany in the 1930s is another. In the former case, after the labor reforms, wage growth dropped significantly below GDP growth, driving down the household share of GDP in exchange for an explosion in the share of business profits.

### **The Japanese Version**

The aforementioned methods are all different ways of boosting domestic savings by limiting the share of total income, or GDP, that households can consume. What made the Japanese model distinctive, as I see it, is yet another way in which savings were boosted, this time through certain hidden taxes designed to constrain the household share of GDP. China and other East Asian countries used the same set of hidden taxes.

The most obvious of these were financial repression and sharply undervalued exchange rates; the former acts as an implicit tax on savings that at its peak during the last decade in China transferred as much as 5 percent or more of GDP from households to borrowers (mostly state-owned enterprises, local governments, and large businesses). These transfers limited the household income and consumption shares of total GDP, and so forced up the savings rate.

Again at the risk of overgeneralizing, it seems to me that the Japanese approach has been the most successful way of

accomplishing this objective quickly and forcefully, but also the most difficult to reverse. Maybe this is no coincidence. Off the top of my head, I think Japan in the 1990s and 2000s was only able to get the household consumption share of GDP to rise from a low of around 52 percent of GDP to around 58 percent of GDP (a still extremely low figure) before the rebalancing effort was derailed. Even today, nearly thirty years after Japan began its difficult adjustment and rebalancing, not only has Tokyo been unable to resolve the resulting debt burden but in fact debt levels have grown steadily during the entire adjustment period.

I do not think this was an accident. While driving up the national savings rate through a combination of financial repression and an undervalued currency turned out to be a very powerful way of doing so quickly, this approach has left countries like Japan and China with specific kinds of balance-sheet distortions that seem especially hard to reverse. As the household share dropped, the share of some other economic sector rose and the latter became very powerful, making it politically difficult to reverse the process once it had reached its limits. The sector empowered by this approach usually was the business sector, but it could also be the government, as in China, or even foreign investors, as occurred typically in certain resource-dependent economies in the post-colonial era.

China, for example, has one of the highest savings shares of GDP ever recorded simply because it has one of the lowest ever household income shares of GDP. This means that if Beijing wants to boost the consumption share of GDP—or to reduce the savings share (which is the same thing)—it cannot

do so by cutting income or other taxes or by raising wages in an orderly manner. It must transfer substantial amounts of income and wealth from those powerful groups who had benefitted disproportionately from three decades of rapid growth. For obvious reasons, this is proving very difficult to do.

What is more, three decades of financial repression and an undervalued currency have left Chinese economic entities heavily reliant on debt to fuel growth and heavily dependent on a current account surplus to resolve domestic demand imbalances. It should have been obvious more than a decade ago that growth in China was so directly dependent on credit expansion and so indirectly dependent on balance-sheet effects (the latter is far more important than most analysts understand but very poorly understood) that we should have discounted altogether Beijing's promises that it would be relatively easy to rein in credit expansion.

## Summary

I want to stress that these are all preliminary thoughts about two very different growth models with opposite approaches to wages, but perhaps there are a few conclusions that we can draw:

- In the high-wage growth model, high wages are the driver of growth. In the high-savings model, infrastructure investment is the driver of growth, with investment subsidized by hidden or explicit transfers from the household sector that simultaneously reduce the household share of GDP and force up the savings rate. Both of these growth models aim for high investment and high wages, but in one case wages lead and

in the other they follow. The former uses high wages to create the market that makes private sector investment profitable and to incentivize innovation. The latter forces up savings and channels these resources into investment to drive up wages.

- Because the high-savings model results in weak domestic demand, especially once investment needs have been largely met, countries that pursue the high-savings model almost always require large trade surpluses to resolve the economy's inability to absorb all that it produces.
- It seems that the high-savings model has been capable of generating more vigorous periods of substantially higher growth over the short- and medium term, but the high-wage model has generated more sustainable growth over the long term. The period of rapid growth under the high-savings model has always been followed by a very difficult adjustment, during which much of the relative advancement achieved during the growth period has been reversed. This may be because the imbalances generated by this growth model have been especially hard to reverse.
- In a globalized world economy, the high-wage investment growth model can be derailed because of its impact on international competitiveness. When transportation costs are very low and there are few trade barriers, high wages cause demand to shift to foreign, lower-wage producers by undermining competitiveness; as a result, rather than force local producers to invest in productivity-enhancing innovations, foreign, low-wage producers simply force them out of business.

Germany's experience of reducing wages during this century

illustrates the problem by showing how the process worked in reverse. For over a decade, Germany suffered from high unemployment as its producers were priced out of the market by foreign competitors. In 2003–2004, Berlin implemented a number of labor reforms—referred to as the Hartz reforms—whose net impact was to weaken the bargaining power of workers and substantially slow wage growth to well below GDP growth. When this happened, Germany's trade deficit became one of the largest surpluses in history as its unemployment level fell sharply. In a globalized world, the way to gain competitiveness is to reduce the real value of wages, either by reducing nominal wages (as Germany did), or by undervaluing the currency (as many Asian countries do).

- The difficult adjustment experienced by Japan and other investment-driven miracle economies may be implicit in the high-savings model. It is almost certain, for example, that China, too, is undergoing a difficult adjustment. While Beijing pledged ten years ago this March that rebalancing demand would be its top economic policymaking priority, this task has been very politically difficult to pull off.

Japan seems to have reached the end of a fairly limited rebalancing that occurred in the 1990s and 2000s, during which consumption rose from 52 percent of GDP to 58 percent, while the country's share of global GDP collapsed from 17 percent to 7 percent. China began the process around 2011, even though it had been promising to do so since at least 2007; consumption in the country [has grown](#) from 48 percent of GDP to 53 percent today, a still astonishingly low figure.

Unfortunately, until the rebalancing is complete, both countries

require large trade surpluses to resolve low domestic demand. As the world becomes increasingly protectionist, however, both countries may be forced into much more rapid adjustment and a possibly dramatic resolution of their debt burdens.

- The trade intervention process begun under the Trump administration is likely to spread to Europe and continue long after the Trump administration has been replaced. This is because as the problem of income inequality becomes an increasingly important political issue, especially in democracies, attempts to reverse income inequality will be undermined by the requirements of a globalized world economy. Democracies will face two options: either ignore income inequality and allow it to get worse, or begin to impose constraints on trade and capital flows so that reforms aimed at reversing income inequality do not lead simply to higher unemployment.

<sup>1</sup> I am currently reading Peter H. Lindert and Jeffery G. Williamson's book, *Unequal Gains: American Growth and Inequality since 1700* (Princeton University Press, 2016). In it, they argue convincingly that nominal per capita income in the United States had been higher than in England for every income level (except the very top) since well before the American Revolution (although for a couple of decades during that period the American figure did fall below that of England). This was in spite of the fact that American families were among the largest in history (half of all Americans were under the age of sixteen, compared to one-third of all English). This suggests that the difference in income per worker was even higher. What is more, the cost of the relevant consumption

basket in the United States was probably lower than in England for every level of income (except, again, for the very top), making the value of per capita income in the United States even higher in real terms than in England.