



Close

Economic development, not redistribution, is key

Print

By Daniel Aronoff

Published: Apr 12, 2004

From Mr Daniel J. Aronoff.

Sir, Amity Shlaes ("Free the world's oppressed entrepreneurs", April 5) conveys Hernando de Soto's fundamental insight that there is vast capital in the developing world that is underutilised because it is frozen and illiquid owing to an absence of defined and enforced property rights. Mr de Soto has persuasively argued that creating legal ownership of assets controlled by masses of poor people in the developing world would unleash a wave of entrepreneurial wealth creation.

Recent research into the sources of productivity difference between countries adds weight to this view. It has been found that total factor productivity (TFP) - that portion of output that cannot be accounted for by size and composition of physical and human capital and which measures the efficiency with which an economy's resources are utilised - is positively correlated with the degree of economic freedom in a country, and that dramatic improvements in per capita gross domestic product could be achieved in the lowest TFP countries if they were to use their resources as efficiently as developed economies. For example, in 1988 India's output per worker was 0.09 per cent of output per worker in the US, while its TFP was 0.27 per cent of US TFP. If India utilised its resources as efficiently as the US, its per capita gross domestic product would nearly quadruple. If Kenya were as efficient in utilising its resources as the US its per capita GDP would jump more than fivefold. There are many examples of countries experiencing a growth take-off after the implementation of market-oriented reforms, the most recent case being the east Asian "miracle" since the second world war, in which TFP growth accounted for a very significant portion of the increase in GDP.

Recent intra-industry research reveals typically large variations in TFP between companies - a variation that widens with the number of companies in an industry. This suggests that the larger the number of companies that can enter an industry and compete, the more efficient will be the leading companies and, hence, the industry average. This result probably obtains because the larger the number of competitors that can utilise their contingent knowledge and experiment with business approaches, the better the chance of some companies adopting highly efficient business practices. This underscores Mr de Soto's point about the importance of empowering the masses by creating widespread asset ownership and minimising barriers to entry.

There is a plethora of evidence in support of Mr de Soto's contention that more progress in promoting economic development can be made by adopting policies that engender efficient utilisation of existing resources than from redistributing resources. Private property, widespread property ownership, low barriers to entry and the rule of law underpin the prosperity of nations.

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US plan needs to boost investment

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From Mr Daniel J. Aronoff.

Sir, The proposed US stimulus plan is seriously flawed. Its purpose is to boost employment, but it is designed to increase spending on final goods and services. The objectives, while not antithetical, are not identical.

Companies are carrying large inventories, and the initial effect of the stimulus will be to draw down on inventories. Whether the initial round of spending boosts employment and, via increases in employment, further rounds of spending, depends on whether companies restock depleted inventories, which requires increased investment and employment. In these highly uncertain times, they may elect not to replenish inventories. If this occurs, the employment increase will be muted.

Given this risk, it seems prudent that the stimulus package includes incentives to invest. An investment tax credit, or reduction in capital gains tax on investments made in the next year or two, would increase the likelihood that the stimulus spurs job creation. Moreover, investment incentives may lead to an increase in private capital investment in financial institutions, another important policy objective.

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The mystery of why the \$700bn Tarp was given the go-ahead by US Congress

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Published: October 7 2008 03:00 | Last updated: October 7 2008 03:00

From Mr Daniel J. Aronoff.

Sir, There is a mystery about why the US Congress last week [approved the \\$700bn Tarp](#) (troubled asset relief programme), the largest government expenditure in history, authorising the purchase of so-called toxic assets.

On the surface, it seems clear a majority in Congress felt the measure required immediate action, in light of a dire warning of impending financial and economic collapse should the government fail to act to revive bank lending, issued from the plan's architects Ben Bernanke, the Fed chairman, and Treasury secretary Hank Paulson. Indeed, there has been no credible challenge to that warning.

But the so-called Paulson plan is disliked by a large number of US citizens who believe it unfairly saddles the taxpayer with financial risk in bailing out the banking sector, and it has received almost universal disapprobation from academic economists and financial market participants, who believe taxpayer dollars could be more effectively deployed by directly recapitalising banks. By creating some form of claim on banks, this would also provide protection for taxpayers.

Indeed, in his testimony before the US Senate last week, George Soros, the financier, reflected this consensus view by warning Congress that Tarp would not provide the capital to enable insolvent banks to lend and that direct investment in banks would have a leverage effect of some 12 times lending for each dollar invested as opposed to a maximum effect of one dollar lent for each dollar of toxic assets purchased.

Yet Congress, including many Democrats sympathetic to Mr Soros's ideas in general, dismissed his recommendations as if he were an impractical dreamer, as they rushed to pass a plan devised by the unpopular Bush administration. Congress did not even bother to ask Mr Bernanke and Mr Paulson to comment on the academic and practitioner consensus view. The mystery is why they did not do so.

If, after a \$700bn expenditure, Tarp does not save the banking system, the US government may lack the capacity to launch another far-reaching fiscal initiative and find itself impotent in the face of a meltdown. Then today's self-congratulating congressmen, who believe they have secured "prosperity in our time", may find their careers and their reputations in ruins. We must all pray that their gamble pays off.

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Beware the fallout from the AIG bail-out

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Published: September 18 2008 03:00 | Last updated: September 18 2008 03:00

From Mr Daniel J. Aronoff.

Sir, While it is clear that the US Federal Reserve extended a financial lifeline to AIG on Tuesday evening in order to stave off the possibility of the company's default triggering a financial meltdown, the action may cause collateral damage that negates whatever benefits it may have secured.

First, the Fed and Treasury have now committed more than \$350bn of US taxpayer money to bail-outs of financial institutions without specific acts of Congress, even though the authority was granted by prior acts of Congress. Expenditures of this size, undertaken without the explicit approval of the elected representatives in Congress, may spark a populist backlash that brings into question not only the commitments made thus far but also the future independence of the US central bank. There is an argument that, in a democracy, the elected representatives should exercise sole authority to spend vast sums. Thus, the Fed may have placed in jeopardy its future independence.

Second, the rationale for bailing out AIG does not include allowing its present shareholders to benefit from taxpayer largesse. Yet, by allowing shareholders to retain 20 per cent ownership of the firm, that is what has occurred. This will invite accusations that the Fed and Treasury are engaged in crony capitalism and serve to undermine support for private financial markets.

Third, the rationale for bailing out AIG is linked to its interconnectedness to the global financial system, yet only the US taxpayer is undertaking a financial commitment. This will cause many to question the benefits of global financial liberalisation, as it appears to place an inordinate burden on the US.

Finally, the bail-out massively exacerbates problems of moral hazard and raises the question of why AIG has not been placed under Fed regulatory authority. It also raises the question of why, in the aftermath of the Bear Stearns debacle, the Fed and Treasury did not pursue regulatory reform in anticipation of the need to provide liquidity backstops outside the commercial banking sector. Following the failure to address the issue, the risk now is that of a move to overregulate financial institutions.

The era of global financial market liberalisation and central bank independence, which has arguably conferred enormous benefits on humanity, may now be drawing to a close as a result of the credit crisis and the US authorities' response to it. One must wonder whether the putative benefits from the recent actions are ultimately more valuable than what they have placed at risk.

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A co-ordinated package to boost US and China

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From Mr Daniel J. Aronoff.

Sir, You rightly criticise the Chinese government ("**China needs a true change of course**", November 11) for opting to stimulate its economy with inward infrastructure investment, which will exacerbate its current imbalances of over-investment and export dependency. Correspondingly, a US stimulus package aimed at increasing consumer expenditure would add to imports and worsen its balance of trade. A sensible co-ordinated stimulus programme would do the reverse; it would have the US invest in infrastructure and China boost consumer expenditure. In that event, the stimulus would have the desirable effect of reducing global imbalances in trade and capital flows by reducing US net imports and Chinese net exports. This type of co-ordination would also address the US infrastructure deficit – including education investment – and thereby improve its long-term productivity.

There has been much focus on international co-ordination of banking support, but there is now a need to focus on fiscal co-ordination as countries move to implement stimulus programmes.

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US is escaping from cost-push inflation

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By Daniel Aronoff

Published: October 14 2005 03:00 | Last updated: October 14 2005 03:00

From Mr Daniel J. Aronoff.

Sir, I agree with your evaluation of the oil shock impact that "Circumstances are not ripe for a wage-price spiral", particularly in the US ("Transatlantic division in monetary policy", October 10). The US is undergoing a transformation in its labour and consumer goods markets that is enhancing flexibility in pricing and eroding the mechanism behind cost-push inflation.

In the past, downward nominal and real wage rigidity was promoted by labour union collective bargaining demands and societal sentiment in support of labour's position. Wage setting through periodic collective bargaining has underpinned the "staggered labour contracts" models employed by academic economists to account for the persistence of wage inflation once kindled.

Thirty years ago, when union membership and prestige were at a peak, collective bargaining determined wages. Today the situation is different. The US has experienced a dramatic proportionate and absolute decline in its unionised labour force and in the last bastion of traditional private sector union dominance, the automotive industry. Unionised firms are shrinking and demanding reductions in wages and benefits. There is, moreover, no widespread public outcry against threatened job losses and wage reductions, much less the outright assault on unions per se, taking place in the automotive and airline industries. All of which underscores the movement to a more flexible wage labour market unencumbered by nominal rigidities.

Product market prices have become more flexible. There appear to be two forces at work. One is a decline in "menu costs", the cost and difficulty of changing prices, in our information age. Automotive companies alter pricing policy monthly, mortgage rates fluctuate daily and prices at the gasoline pump are adjusted hourly. The other is the increasing price competitiveness of consumer goods groups. The bellwether is Wal-Mart's rise as the premier retailer, slimming margins to suck market share from traditional retailers.

In a flexible price economy, cost-push inflation is less likely to take hold because the contractual and nominal rigidities thought to be required to make the process take hold are not present. We should rather expect to see relative price and wage adjustments that will steer the US economy away from inflation - absent a serious monetary expansion - and toward full employment.

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More competitive Japanese bank sector would stimulate growth

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By Daniel Aronoff

Published: June 9 2005 03:00 | Last updated: June 9 2005 03:00

From Mr Daniel J. Aronoff.

Sir, I applaud your querying recent moves by the Japanese authorities to reduce government expenditure and rein in monetary growth ("Now is not the time to tighten belts", June 7). The rationale posited by Japanese authorities for reducing fiscal expenditure - that the government cannot afford to continue its "unsustainable" deficit spending - reminds me of Keynes's comment on the UK government's refusal to countenance a budget deficit in similar circumstances: "They claim they cannot spend because they have not got the money, but they have not the money because they will not spend."

The matter of monetary policy is more complicated. The Bank of Japan correctly maintains that the banking sector is no longer insolvent and is awash in liquidity, which means monetary stimulus will not translate into increased demand. It may be that further structural reform, in the banking sector and throughout the Japanese economy, is required.

Japan's heavily regulated banking industry is an oligopoly with lending practices strongly influenced by government. For understandable reasons, the current directive counsels extreme conservatism in lending. Such policies may help stave off future banking failures, but at the cost of economic contraction.

A more competitive banking sector would foster more innovation in lending and offer savers more genuine choice, both of which would render monetary stimulus more effective. Reduced barriers to entry in the many protected domestic industries in Japan would enhance efficiency and growth and engender more profitable lending opportunities for banks.

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World is heading for meltdown with an unsustainable currency pattern

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By Daniel J Aronoff

Published: December 13 2004 02:00 | Last updated: December 13 2004 02:00

From Mr Daniel J. Aronoff.

Sir, In a series of FT articles over the past few months Martin Wolf has laid out a persuasive case that the current pattern of saving, investment, consumption and alignment of exchange rates among leading currencies and countries cannot sustain itself indefinitely.

Put simplistically, the US consumes too much relative to its output, Asia saves too much and invests in low (and potentially negative) return dollar assets to maintain an undervalued exchange rate in order to stimulate export-led growth, and euroland is getting stuck with the brunt of a dollar depreciation that is choking its export sector, thereby damping its growth rate.

This pattern is unsustainable because the US cannot run large current account deficits and increase external liabilities without limit: there is, in theory, a mathematical limit and, practically, a nearer-term meltdown point at which capital flight will likely set in.

Mr Wolf is challenging policymakers to act now to avert the possibility of a meltdown later. The vexing question is how to do it.

The developed economies have relied for a decade on the engine of US consumption to maintain growth. Thus the seemingly sensible proposition that US citizens begin to live within their means could, in a contemporary version of Keynes' "paradox of thrift", trigger worldwide recession.

And besides, the US cannot stop consuming beyond its output so long as Asia continues its dollar asset buying binge, as Mr Wolf has pointed out.

Moreover, the massive monetary expansion in Asian currencies caused by unsterilised dollar asset purchases has not yet produced inflation, which might otherwise act as a "market" channel for the terms of trade to self correct.

This leaves a retrenching of Asian official intervention, allowing appreciation of Asian, excluding Japan, currencies to induce a reduction in the US current account deficit, as the only viable policy option (Japan may still require intervention to avoid a disastrous deflation).

Yet this appears unattractive to Asian governments because it would place the burden of adjustment on their economies. A fiscal deficit would, however, provide an offset that could allow employment levels to be maintained.

Deficits in the form of income or consumption tax reductions would increase consumption would reduce over-saving, spur the development of non-tradeable goods markets within Asian economies and add demand for US exports.

The current slack in the US labour market and excess capacity in the US manufacturing tradeable goods sector will ensure that a spike in export demand does not immediately kindle a serious dollar inflation problem. An adjustment of this type would stand a chance of setting the world macro-economy on a sustainable full employment path and avert the possibility of dollar meltdown.

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