The true causes of this week's global market correction

Dr Woody Brock | SED | 26 August 2015

The four reputed sources of today's market downturn are (i) China's distress – both in its financial markets and in its economy; (ii) the sloppy resolution of the Greek Crisis and its demonstration that the European Monetary Union rests on very shaky ground with no one in charge, not even Germany; (iii) the possibility that the US Fed may finally raise interest rates; and, (iv) the realisation that emerging market economies will not live up to their potential to empower global growth, especially in the case of nations dependent upon commodity exports.

Each of these developments on its own represents a valid source of concern to global investors – concern, but not panic. However, when all four developments come to the fore at the same time, no one should be surprised that global pandemonium has ensued, especially when allowances are made for the roles of trend-following behavior, of indexing, and of carry trade shenanigans in amplifying market turmoil.

Many readers of this Memo will know much more than we do about whether and how far markets will continue to drop. Our own view is that this correction is long overdue. It is also not over because the true problems underlying market concerns are rarely identified, are much more serious than the four developments cited above, and are not being addressed by governments. Here, we simply wish to put today's correction in proper perspective by discussing these deeper issues.

THE TRUE CULPRIT – STAGNANT ECONOMIC GROWTH WORLDWIDE

Global GDP is growing at an anemic rate of about 2.8%, or possibly even less were the truth known about China's growth rate. It could and should be growing at 5.5% or even higher given the boost to global consumption from low oil prices.

It is astonishing that the role of stagnant global growth is rarely cited for what it is – the true cause of today's distress on Main Street ***and*** on Wall Street. Were the economies (not "the markets") of the world growing strongly, none of the four developments cited in the first paragraph would have occurred, and there would be no financial crisis.

In past essays, we have stressed why growth is substandard in all major economies. We found that interest rate levels (and hence monetary policies) are largely irrelevant in explaining slow growth, and that the true reasons for stagnation lie: firstly, in "incentive structure" issues that are mentioned only once for every fifty times that the Fed is mentioned; secondly, in the explosion of corruption worldwide; and, thirdly, in the collapse of proper macroeconomic policies.

1. Structural reforms and incentive structures

To take an example, consider the stagnation in Europe. Eurosclerosis is 40 years old and is getting worse because of the ongoing failure of governments to deregulate labour and product markets. Businesses have no incentive to hire a worker if they know they can never fire him. Note that this European crisis far predates problems mistakenly attributed to the advent of the euro. Had the correct reforms been made throughout Europe, including in Greece, then there would be no Greek/euro crisis today.

In Japan, Prime Minister Abe has repeatedly said that the failure to implement structural reforms has been the true cause of Japanese stagnation. What about the US? Is it exempt from such criticisms? No. The most important economic statistic of 2014 was that more small businesses closed than opened for the first time on record. Is this any surprise when, for example, the number of permits needed to open a restaurant in NYC has increased from two to 15 during the past 40 years of regulatory overkill? Phillip Howard's new book *The Rule of Nobody* brilliantly documents the adverse effects of regulatory excess.

2. Global corruption and its impact on incentives

Second, there is the problem of endemic corruption almost everywhere on earth, a problem that has only gotten worse since the reported End of Communism. Does anyone recall Khrushchev or Mao being accused of rampant corruption? Contrast the corruption levels in both Russia and China before and after liberation from communism. Smaller economies throughout Asia, Latin America, Africa, and Eastern Europe are also riddled with corruption.

What matters is that economic growth is slowed down by the adverse incentive effects of corruption. For example, without the Rule of Law, and without connections, average citizens have little incentive to start businesses. Add in Crony Capitalism, and vast amounts of financial resources get misallocated resulting in even slower growth. Mal-investment becomes the order of the day, guaranteeing ever-growing debt burdens which lead to financial crises. We have read this script many times before.

In our view, were the issues of adverse incentives and corruption to be remedied worldwide, global growth could be over 5.5% on a sustained basis, just as was forecast in those heady years when James O'Neil of Goldman Sachs told us all that a bright global economic future would be assured by the rise of the BRICS nations. Issues of incentive structures and corruption were rarely, if ever, mentioned at that time, even if their importance should have been obvious to any serious commentator. It turns out that the term BRICS was well chosen since, with the possible exception of India, these five economies now resemble a pile of discarded bricks.

Regrettably, these issues of structural reforms and corruption will not be tackled in the near future for two reasons. First, there is no political will to do so. Vested interests are simply too strong given the low level of political courage we witness. Second, those economic pundits who should be highlighting the true sources of distress on the Main Streets of the world fail to do so, preferring instead to chatter endlessly about Janet Yellen's dilemma as to whether to finally raise rates. The imbalance of their concerns represents gross professional negligence, in our view.

As long as these foundational issues remain ignored, the world will and should witness markedly substandard growth that will hasten the bankruptcy (or whatever form this takes) of the welfare states of the West. It will also exacerbate the plight of some thirty emerging economies that could otherwise achieve the growth rates of Singapore, Hong Kong, and South Korea.

3. Collapse of macroeconomic policy

What is the most fundamental pillar of macroeconomic policy? It is Jan Tinbergen's concept of "controllability" that we have stressed many times before.

Tinbergen, the first winner of the Nobel Prize in economics, introduced this all-important concept in the early 1950s. Kenneth Arrow and Mordecai Kurz of Stanford University subsequently developed it further, and formalised it in their 1970 book on optimal fiscal policy. We learned that, if policy makers wish to restore long-run growth, full employment, and price stability – their three goals – then they would need to utilise at least three policy levers to do so. This is a theorem, not an opinion. Equivalently, monetary policy alone cannot and should not have been expected to cure economic ills and restore growth. And it did not do so. Fiscal policy is also needed – in particular, public investment in infrastructure investments that earn a high positive rate of return on invested capital.

In the US, under the Obama regime, debt has increased by some 11 trillion dollars. According to the CBO, not even 1% of this debt burden was "invested". Until the global crisis of 2008, China did invest hugely in projects with positive long-term rates of return (as properly measured in the Arrow-Kurz sense). During this period, we never read of massive Chinese debt problems. All this ended after 2008 when China mal-invested in see-through cities and other wasteful projects that caused the nation's levels of "bad debt" to explode to where they are today.

But will fiscal and monetary policy suffice to restore good growth? No. A third set of policies are needed that target long-term growth as opposed to cyclical recovery. These are the incentive structure reforms that we touched upon above. Regardless of whether monetary and fiscal policies are good or bad, North Korea will never grow because its incentive structure makes it irrational for ordinary Koreans to wake up and start thousands of entrepreneurial small businesses, precisely what the reverse mirror image structure of South Korea guaranteed.

We review this logic to highlight how inappropriate today's reliance on monetary policy is – not to mention the obsession of economic commentators on the Fed's next move. Worse, whereas the primary concern of macroeconomic policy is supposed to be Main Street and not the markets, the Fed now seems to have put "market concerns" ahead of Main Street's needs. The significant damage being done to insurance company balance sheets and to retirees' living standards from a "0% interest rates forever" policy is scarcely addressed compared to the need to forever placate the markets.

Pundits should have been focusing on the need for profitable public investment, as well as the need for incentive reforms. And, serious policy-makers like Janet Yellen and her colleagues overseas should have been preaching the Gospel of Macro-Controllability from their ramparts. But they have been largely silent on these critical issues, thus encouraging the now dominant view that macroeconomic policy is monetary policy. Incroyable!

POSTSCRIPT ON CHINA

We have long disagreed with consensus views about the inevitability of the supremacy of China. Its excessive reliance on investment and exports as its engine of growth guaranteed what is happening today, including the nation's need to devalue the yuan in a dangerous manner wholly inappropriate for the second largest economy on earth. The government of China has lied about the magnitude of its total debt, about the level of commodity inventories, and about the GDP growth rate.

The megalomaniacal President Xi and his Premier Li have acted like King Cnut of Denmark who attempted to calm the ocean's waves by ordering them away. These politicians' astonishing conceit that they could order an end to market turmoil – regardless of its true causes – is something we might have expected from North Korea's dictator, but hardly from brilliant Chinese policy makers. Well, global markets are now teaching Xi and Li who in fact is the boss.

As for Xi's well-publicised fight against corruption, those being persecuted are often his own current or potential adversaries. Those mega-corrupt communist "Princelings" have largely been exempt from his dragnet. But note the paradox within his strategy. Xi claims he is rooting out corruption so as to strengthen the Communist Party. But it is this Party that is the very source of the corruption he claims to be fighting. "Power corrupts, and absolute power corrupts absolutely" as Lord Acton famously pointed out well over a century ago.

We believe the remarkable work ethic of average Chinese workers, along with the nation's remarkable infrastructure, guarantees the continued ascendancy of China as an economic power. However, its rate of progress will be much lower than the consensus has expected for the reasons detailed in our recent profile on the true risks to China's future growth. Recall that in Stages 4 and 5 of Walt Rostow's Five Steps of Economic Progress in emerging markets, rapid growth requires a shift from a top-down authoritative system that works well in Stages 1 to 3, to a decentralised bottom-up system where consumers and small businesses are in charge – not well-connected politicians and their cronies.

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