The global slowdown - China is not the problem

Dr Woody Brock | SED | 01 December 2015

Data reveals much about today's world economic slowdown, in particular the relative contribution to this slowdown by individual nations and/or blocs thereof. Inflation, bond markets and stock markets are all functions of growth. Stocks are arguably the most sensitive to growth, because of the impact of the growth rates on earnings.

What can we say about all this? And what does the future bode?

Several issues arise in interpreting data (refer Figure 1), and these must be resolved before a meaningful forecast of future global growth can be arrived at. The most important point is that, absent a causal explanation of why growth has slowed as much as it has in each nation or region, forecasting future growth is all but impossible. In this regard, the data in Figure 1 say nothing about causality.

What does the consensus say about the origins of low growth? And, in what way do we disagree with the consensus?

Figure 1: Real GDP CAGR

	2000–2014	2008–2014	2010–2014
World	6.4%	3.7%	4.7%
Advanced economies	4.3%	1.5%	2.7%
European Union	5.7%	–0.2%	2.8%
Emerging market & developing economies ex-China	9.9%	5.3%	5.3%
Brazil	3.2%	2.6%	2.1%
China	9.8%	8.6%	8.0%
India	7.2%	7.4%	6.4%
Japan	0.7%	0.3%	0.7%
Russia	4.1%	1.0%	2.4%

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South Africa	3.1%	1.8%	2.3%
United States	1.8%	1.4%	2.1%

Sources: International Monetary Fund, World Economic Outlook Database, April 2015; SED

Figure 2: Share of Global GDP

	2000	2008	2014
World	100%	100%	100%
Emerging market & developing economies ex-China	17%	24%	26%
European Union	27%	30%	24%
United States	31%	23%	23%
China	4%	7%	13%
Japan	14%	8%	6%
India	1%	2%	3%

Sources: International Monetary Fund, World Economic Outlook Database, April 2015; SED

THE CONSENSUS STORY AND ITS DEFICIENCIES

There are two stories underlying the consensus story.

First, the great slowdown in China is responsible for lower global growth due to a "domino effect" of rarely specified variety. China's annual growth is currently estimated to be between 4% to 5% when reasonable adjustments are made to problematic official data. Line 6 of Figure 1 presents official Chinese data that paint a much rosier picture. A more accurate growth rate for the 2010-2014 period would have been 6.5% as opposed to the official 8% shown. Looking forward, our forecast for Chinese growth during 2015-2018 is around 4.75% per annum, a far cry from the 7.5% consensus forecast for this period issued two years ago.

This Chinese slowdown has had a large impact on commodity prices. But, while commodity price declines may matter a lot to investors, they have little impact on the level of real economic activity on most Main Streets, other than in places like Western Australia and the Canadian Northwest.

It is easy to forget that the level of economic activity in most nations increasingly centers on services, not goods, especially in the advanced nations. As one observer joked, the US is becoming a nation of burger-flippers, disc jockeys, and nurses. Indeed, 80% of the US workforce now provides services. China's slowdown has little if any impact on most service sectors, as trends in US employment data make clear.

Of course, the Chinese slowdown is impacting the real economies of a number of its neighbors, as well as Japan and Germany whose export industries have been hurt. Moreover, China's currency devaluation has slightly depressed US growth as new data confirm. But none of this explains the magnitude of the slowdown in global growth seen in Figure 1. We show growth rates over three periods. The middle period of 2008-2014 should reveal the lowest growth rates everywhere, since this sample brackets the Global Financial Crisis during which growth collapsed. The final period of 2010-2014 should reveal an increase in growth compared to the middle regime, for these were the years of recovery from the GFC. But note that in the case of emerging economies ex China, there was no recovery in growth. Nor was there in China.

To put matters into even better perspective, consider the data of Global Share of World GDP data in Figure 2. [Fractional data points have been rounded up to the next integer.] We see here that the largest economic bloc on earth is that of emerging and developing economies ex China (henceforth "developing" economies ex China). Their 26% share is trailed by the European Union's 24% share, the US's 23% share, and China's 13% share.

Now return to Figure 1 – note the significant slowdown in the developing economies ex China, where the growth rate has fallen from an average 9.9% per annum in the 2000-2014 period to 5.3% during the past four years. Not only is this bloc's economic size much larger than China, but its growth rate has fallen much more than China's.

Was this developing economy slowdown due to China as is implicitly assumed by the consensus? No, it was not. The causality in fact runs in both directions, and the main culprit has been the role of rampant corruption by the kleptocrats who run most emerging nations. But why is the role of kleptocracy in depressing growth so little discussed? And why is this bloc of nations rarely analszed as a whole?

Note an irony here. In 2004, and then again in 2010, vigorous growth in emerging economies as a whole was touted as the great white hope for future global growth. It was widely predicted that over 2 billion people would be added to the global middle class by 2030. Remember the acronym BRICS created by James O'Neil of Goldman Sachs? His choice

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of an acronym was felicitous: BRICS has now been reduced to a pile of bricks, as the data make quite clear.

If the consensus pays too much attention to China, and too little to what ails emerging markets in general, it also pays too little attention to the impact on global growth of ongoing stagnation in Europe and Japan, and to a lesser extent in the US. Again, the data in Figure 1 tell a distressing tale in this regard. Today's slowdown is truly global, with economies everywhere contributing to it.

The second part of the consensus story lies in its claim that the GFC has been the cause of ongoing stagnation. The GFC debacle was countered by very expansionary monetary and fiscal stimulus (if belatedly in Europe), and the crisis predictably ended almost everywhere. Could the aftermath of this crisis somehow explain the painfully slow rate of recovery in so many nations despite unprecedented monetary easing almost everywhere? No. Not only is the lingering impact of this crisis much exaggerated, it used to cover up those far more disturbing developments that are responsible for poor growth. Note that growth in the European Union has been sclerotic for decades, and for reasons having nothing to do with the GFC.

A MORE CONVINCING STORY

To gain a better understanding of the global slowdown, it is necessary to identify the causes of slow growth in each of the above-mentioned nations and regions, and not attempt to pinpoint a single cause (e.g., China) since none exists.

To the extent that poor policies are responsible for low growth, as opposed to natural disasters or demography, the relevant questions are (i) which policies if adopted would stimulate growth, and (ii) what is the probability that such growth-oriented policies will get adopted? It is also necessary to know whether today's slowdown is cyclical or secular (as in Lawrence Summers' prediction of continuing stagnation for non-cyclical reasons). This is important because the cure for a cyclical downturn is altogether different from the cure for new secular trends.

Here we sketch answers to all these issues. To anticipate, we give low probability to the adoption of policies that could reignite growth. The principal reason why lies in strong opposition by vested interests to needed reforms. But there is a silver lining – higher growth will surely be needed regardless of vested interests, if most nations are to be able to make their promised pension and medical payments to their citizens. It is never pointed out that the greatest vested interest of all is the expectations of prospective pensioners for decent retirements and medical coverage. This reality will reshape the global landscape of "vested interests" during the next quarter of a century.

In Part A, we argue that today's slowdown is secular and not cyclical. In Part B, we review what ails growth in the economies cited above, and what can be done to remedy matters. We also discuss to what extent proper policies will be adopted.

A. Business Cycles versus Secular Trends

To begin with, can today's slowdown be regarded as cyclical? Or is it secular, stemming from longer-run structural changes impeding growth? By cyclical we refer to the types of slowdowns associated with classical business cycles, reviewed below. By secular, we mean changes in longer-term growth rates due to either of two developments. First, structural changes unrelated to government policies (e.g., the advent of baby-boomer retirement) can slow growth, and little can be done about these. Second, policy changes – or the lack thereof – can significantly impact growth. Examples include the pro-growth policies introduced by China in 1980, by the Howard-Keating administration in Australia in the early 1980s, and by the Reagan/Thatcher reforms of the early 1980s. All of these boosted growth, just as the policies of their predecessors depressed growth.

As for classical business cycles, a remarkable transformation occurred during the 20th century. From 1880–1960, the principal (but not sole) drivers of business cycles were inventory cycles, and bank busts. [The US Fed only came into existence in 1911.] In the case of the inventory cycle, technology was the culprit. Henry Ford's production lines ran at one speed, and every man had to be at his post for the line to work. When auto inventories were too high, the entire plant had to be closed, and most workers laid off. But, without any production of cars, the production of rubber, glass, steel, coal and coke would also be idled. The correlation between the industrial sectors was very high, so all the dominos fell at once. Matters were made worse by the absence of worker safety nets. This translated into a high correlation of consumption and production.

By mid-century, things were changing. The Fed now existed, a social safety net was put in place, and variable-speed production lines were introduced. A couple of decades later, "just-in-time inventory management" was in place. At the same time, starting under the Kennedy administration, counter-cyclical Keynesian policies began to be used. Thus classical business cycles ceased to exist. The decade-by-decade standard deviation of GDP fell by more than 70% between 1900 and 1980[1].

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Nonetheless, for non-inventory reasons, business cycles continued to exist. The causes have been oil-price shocks, interest-rate shocks, and asset-market busts, in particular. In the analysis of recessions worldwide, the number one culprit has been asset-market booms and busts, ranging from the Long Term Capital disruption, to the Asian and Russian crises, to the bursting of the US technology bubble in 2001, and to the bursting of the US housing bubble in 2008. When the history of modern day economics is written, ever-looser standards in the credit markets will be seen to have been the root cause of macroeconomic distress during the past four decades. The principal culprits here are ever-lower margin account requirements, financial market shenanigans enabled by "financially innovative" models, excessive home-equity loans, and rock-bottom down payments on houses and other durables.

Making matters worse, the need to remedy asset busts gave rise to ever-more accommodative monetary policies. The ever-lower interest rates that resulted in turn laid the groundwork for more bubbles in the future. Accompanying these developments, policy makers and the financial markets came to believe that monetary policy is macroeconomic policy. This view is both incorrect and dangerous to the economic health of nations, as we have often stressed.

Relevance to a World without a Cycle

What is interesting today is that, while we are supposed to be in a global recession of sorts, there is no business cycle at work. Moreover, there has been no asset-market bust. There is the energy price collapse, of course, but this is most likely a net plus for global GDP given its stimulus to consumer spending. Yet all we witness is "disappointing" growth, quarter by quarter, year after year. So what really is behind all this? Why the slowdown? What exactly are the non-cyclical and secular developments that are responsible region by region?

B. What really ails growth worldwide?

1. Widespread ignorance of true macroeconomic policy

The growing irrelevance of macroeconomic policy, as currently practiced, is a major reason for stagnation in most regions. To begin with, recall Tinbergen's "controllability theorem" of macroeconomics proving to us that, if a nation has N macroeconomic goals, it must have at least N independent macroeconomic policy levers, if those goals are to be achieved. (Independent means that each of the levers can be used independently of the others.) Starting with Keynes, the goal of macroeconomic policy was to stabilise the business cycle – this and no more. More specifically, the twin policy goals were to maintain steady and low inflation in the markets for goods and services, and to stimulate full non-inflationary employment.

The two policy levers required to achieve these goals were monetary and fiscal policy respectively.

Importantly, it was never a goal of macro-policy to maintain stability in asset prices. Nor should it have been – for both theoretical and empirical reasons, there has been no correlation between asset price cycles and goods-prices cycles. Thus, it would have been impossible to have used monetary policy (aimed at prices on Main Street) to control asset market bubbles[2].

What about the altogether separate goal of stimulating strong long-term growth – aside from enhancing cyclical stability? What creates fifty years of robust growth in South Korea versus decades of depression in North Korea? Curiously, despite the advent of growth theory in the 1950s, and incentive structure economics in the 1960s, conventional macroeconomics never incorporated the insights from these theories. The discipline to this day has remained centered around fiscal and monetary policy, and has excluded those non-fiscal and non-monetary policies needed to ensure strong long-run growth. Most commentators incorrectly assume that the achievement of a cyclical "recovery" somehow translates into robust longer-term growth. As we are seeing, it does not[3].

Let us review those policy deficiencies that have stymied long-term growth. We shall do so via a brief worldwide tour of what ails whom where.

2. What went wrong and why – Region by region

- **The US**

Consider growth in various sectors of the economy. For a number of reasons, private sector investment during today's recovery has been and should have been sluggish. Housing starts have come back, but nothing approaching the levels of yesteryear. This was fully predictable. In the corporate sector, growth in capital expenditures and most other forms of corporate investment has been sluggish. But why? One of the most important reasons is that investment spending as a component of GDP is measured in dollars as opposed to, for example, units of productivity enhancement.

The problem here was best documented in a paper by Brent Neiman of the University of Chicago that we reviewed a year ago. He and his colleagues identified and explained the slowdown in investment spending by noting the remarkable decline in the cost of capital goods made possible by the digital revolution. As a result, the Price x Quantity expenditure of dollars on investment spending can fall annually, thus slowing the growth of GDP, regardless of whether the "true" quantity of investments has fallen at all! Neiman shows that this has been an ongoing story for thirty years – and it has accelerated during the past decade. Additionally, the data on investment spending miss the extent to which companies now invest ever more on "human capital" (software, training, innovation), almost none of which is captured by the official data.

Consumption and trade have recovered in a fairly normal manner. Fiscal stimulus was huge between 2007 and 2011. But thereafter, the US deficit fell sharply by over half a billion dollars and this slowed growth.

What was missing in US macroeconomic policy was extensive public-sector infrastructure spending – provided such investments would have yielded a high rate of return on capital (which they certainly could have given the lowest cost of capital in decades), and given the payoff from investing in badly depreciated capital stock. In these pages, and in the author's 2012 book American Gridlock, a proposal was made for $10 trillion Marshall Plan of "good deficit" spending on infrastructure to last over 20 years. This would start with a new cyber attack–free electric grid using random-access grid technology to deter cyber-espionage. Next would come high-speed East Coast rail expenditures. Finally, some 800 dilapidated tunnels and bridges would not simply be "repaired" but completely replaced with carbon-fiber-based platforms that last up to 1000 years. Former Fed Chairman Bernanke has recently endorsed infrastructure spending of exactly the same amount as we initially proposed.

Alas, such proposals went nowhere due to:

- The widespread distrust of government and of deficits of all kinds;
- The failure to understand the difference between "good" and "bad" deficits; and,
- The failure to understand the astonishing increase in long-term growth made possible by investment spending – in particular by its employment multipliers and productivity gains. We do not blame politicians for this failure as much as we blame the pundits who ought to have known what was needed, and who should have trumpeted the virtue of public over private investment during the past decade. As Arrow and Kurz pointed out in their celebrated 1970 redefinition of capitalism, true capitalism implies that, at each point in time, the nation should invest its total available wealth wherever it earns the highest rate of return, whether this be in the public or the private sector.

Making matters even worse, US budget priorities (along with its sequestration policies) are undermining growth even more. More specifically, it is not the size of the deficit but rather the composition of spending that is the problem. The share of tax revenues going to transfer payments is steadily increasing at the expense of discretionary expenditures on the nation's human and physical capital stock (basic research, training, education, and non-highway infrastructure). Indeed, the Congressional Budget Office recently predicted that the discretionary portion of the budget will shrivel by 2025 to a pathetic 2.3% of the federal budget, far lower than at any time in the past 40 years.

But the US needs more than "good deficit" stimulus. Its long-run growth increasingly suffers from growing regulations of all kinds, documented so clearly in Phillip Howard's excellent 2014 book, The Rule of Nobody. On the tax front, the Tax Foundation has just ranked the US dead last out of 34 nations in its abusively high rates of taxation on corporate income.

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It ranks 32 out of 34 in the foundation's more general Tax Competitiveness Index. As for small businesses, more closed than opened during 2014 – perhaps the most telling statistic to have been published in decades. This has never before happened. Needless to say, President Obama and the liberal press paid no attention to this all-important news bulletin.

To conclude, the US requires very significant infrastructure investment and a good dose of deregulation if it is serious about achieving higher long-run growth. The probability of either of these two developments happening over the next dozen years is about 15%, in our view. The main culprit here, other than our appalling lack of political leadership, is a fundamental misunderstanding of what the government could be doing to restore long-run growth. That is to say, a misunderstanding of proper macroeconomic policy. Regrettably, the US, unlike the other major economies, can afford to postpone serious policy changes without paying too high a price for doing so – at least in the short run. This lowers the probability that better policies will be adopted.

- **B. Continental Europe**

The reforms needed in Europe are very different from those needed in the US. The slow growth almost everywhere on the continent (except for Germany) stems from the failure of most governments to liberalize their product and labor markets. This is particularly true of European nations in the south. It was liberalisation of the labor markets that transformed the pre-1993 Germany (the Sick Man of Europe) into the post-2000 Strong Man of Europe. Higher growth and lower unemployment followed just as night follows day. Mandated shop closings at 5:00pm, minimum wages, inflexible holiday schedules, inabilities to lay-off workers, and high taxes on wages borne by companies are surefire ways to kill incentives and growth. The UK has fared better than the continent both in growth and employment, primarily because of its more flexible markets.

Looking forward, a number of continental nations will finally begin to deregulate. Germany and several Scandinavian nations have already done so. Others will slowly follow suit. One reason for optimism here is that stronger growth via deregulation is the only politically painless way by which most nations will be able to afford those politically untouchable old-age benefits they have promised. Necessity really is the Mother of Invention. We give a 25% chance of significant reforms during the next ten years.

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- **C. Japan**

Prime Minister Abe has repeatedly made clear what Japan needs to revive growth. He has stated that fiscal and monetary policies will not suffice to restore growth to Japan. What matters most he has said is the "third prong" of his three-pronged strategy, namely structural reforms involving busting up labor cartels, rice farmer cartels, and service-sector inefficiencies. He admits these are the true barriers to growth in Japan. We give a 20% probability to such reforms being implemented during the next five years. One reason for hope here is that Japan may be reaching a breaking point, especially given its demography and its debt levels. Growth will have to be engineered, and structural reforms are the only way this can be achieved. In this regard, Japan is different from the US, which can postpone reforms for many more years.

To be fair, Abenomics is showing some signs of working. Real wages are rising slightly. Today's slightly negative growth rate might seem serious, but it is not given Japan's shrinking workforce and its low productivity level. Indeed, its potential growth rate is now estimated at 0.5%, and any shock such as a consumption tax can easily push potential growth negative. Finally, unemployment has edged down to 3.4% now from 4.1% after "quantitative and qualitative" central bank easing began. But robust growth will require major structural reforms.

As for its demographic fate, this is not a problem which the right policies can solve, except for the government'sability to encourage more women to join the workforce as it is now doing.

- **D. China and most other emerging economies**

This category consists of so many nations that it is risky to generalise about the causes of the slowdown, and about what remedies are needed. We recently analysed the case of China in some detail – what has gone wrong there, and how to restore growth. In this final section, we build upon that analysis to put the plight of other emerging economies into perspective.

You might recall our review of the analysis introduced by MIT's Professor Walt Rostow in his 1960 book, The Five Stages of Economic Growth. He showed how undeveloped economies virtually always go through five stages of development starting with low productivity, low investment agrarian economies and ending up with high investment, high productivity, consumption-based economies. The fundamental question posed by Rostow's taxonomy was: What can make the time between stage 1 and stage 5 the shortest possible? That is, what generates optimal growth? Rostow did not answer this. However, subsequent research did. The most interesting findings concern (i) the distinction between top-down and bottom-up growth, and (ii) the role of corruption.

Top-down versus bottom up growth

In the first three stages of growth, it is beneficial to have Strong Men direct the development of a new economy - development which is infrastructure heavy. Stalin created very fast growth by having dams built in the Ural Mountains, and Krushchev followed suit, and China invested in infrastructure for 30 years with a scope and at a rate that was unprecedented in modern history. This was the main reason (along with its export strategy) for the stunning rate of the nation's transformation from a stage 1 to stage 3 or stage 4 economy today.

In the last two stages of development, however, this story gets reversed. What matters is the bottom-up growth of production and consumption via the rapid formation of myriad small, innovative businesses. Top-down management frustrates such growth due to the unhealthy interferences it introduces. What is needed is the informationally and decisionally decentralised system of market capitalism with its Invisible Hand. One thinks of the nature of successful bottom-up growth in the Asian NIC countries such as Singapore and Hong Kong.

The role of corruption

At a theoretical level, the simplest reason why corruption kills growth is that optimal growth requires an optimal allocation of capital, as is formally proven in economic growth theory. But corruption virtually by definition causes capital to be misallocated towards suboptimal projects supported by crony capitalists. Malinvestment of this kind slows growth.

Corruption is almost always part of the economic transformation in stages 1 to 3. Payoffs are made when roadways are constructed, and so forth. However, the benefits from achieving infrastructure development (as China did) are enormous, and corruption does not necessarily slow growth very much.

However, this is not the case in the latter stages of development. The lack of the rule of law, the lack of property rights, and a corrupt judicial system kill the incentives of entrepreneurs to start those myriad small businesses required for stage 4 and stage 5 growth to occur.

To restate this, the loss of growth exacted by Crony Capitalism accelerates as nations progress towards stage 5 of development. China today is suffering from the two inconsistent goals of President Xi Jinping. First, he wishes to clean up corruption "so as to strengthen the Communist Party." Second, he seeks a transformation of the county into a consumption-driven rather than an (top-down) investment-driven economy. The problem is that power corrupts, and absolute power corrupts absolutely. In this regard, a strong communist party is the source of the very corruption that kills the kinds of bottom-up growth that only entrepreneurs can create.

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A nation-by-nation analysis is obviously required to assess the probability that different nations succeed in reducing the nature and levels of corruption. For example, the kind of corruption in India is very different from that in Venezuela, Nigeria, or China. Such an exercise lies well outside the scope of this essay. Nonetheless, the common denominator is that corruption exacts an ever higher price everywhere as time goes on, regardless of the particular country involved and the particular type of corruption involved.

ENDNOTES

1. The seven reasons for greater GDP stability are discussed at length in "The Ability to Outperform the Market" appearing in *Revista Internazionale di Scienze Sociali*, 2007, number 3, pages 375-376, Milan.

2. Other "prudential" policies have been used to control asset prices, such as minimum down payments on asset purchases, or targeted margin and reserve requirements. However, use of such policies fell by the wayside during the deregulatory Greenspan era of "markets know best" with wholly predictable consequences.

3. At the level of global policy, there is the embarrassment of the United Nations' "Sustainable Development Goals" program. As its title suggests, this is a meaningless enumeration of the goals to be achieved in aggressively raising living standards worldwide. There are seventeen goals in all, covering the environment, poverty, education, and justice. A jolly good wish list. As for the specific policies needed to achieve these (a reduction in corruption anyone?), very little is said.

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