Weekly Economic Commentary

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by Carl Tannenbaum

of Northern Trust

China: Two different stories, one conclusion

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Analyzing the world's most-populous economy has, of late, involved a study of two separate stories. One story is set inside the ring roads and defined urbanization of Beijing, where officials meticulously align their talking points around slower but stable gross domestic product (GDP) growth, more-robust job creation and implementation of reforms over the next decade that should transform the Chinese economy into a sustainable, consumer-driven model.

The other story is in the financial world, a place moving in a chaotic, unpredictable orbit where the shadowy multi-trillion-dollar galaxy of wealth management products spins ever-faster, with credit-driven inertia hurtling it in unknown directions. Of late, these two stories feel increasingly out of synch, raising the possibility that meteoric markets could collide with the cold reality of a slowing Chinese economy.

The most notable change in the air around Beijing is that government officials are downplaying the official GDP growth target of 7.5% for 2014 and changing the focus to job creation. This is seen as the government's way of informally acknowledging that the official growth target will be missed. This has not happened since 1999, and that underage generated a good deal of controversy. This slowdown is being framed as a part of reform, with the gradual change to more-modest growth expected and even embraced.

Source: Haver Analytics

The slowdown in GDP, however, is not what worries the markets. It is the fear of financial excess that concerns them.

At first glance, money supply and credit generation (using bank asset growth as a proxy) appear to be growing at 10-year lows – hardly a threatening economic environment. Low credit growth would even suggest that talk of asset bubbles and a painful correction is, perhaps, excessive.

However, anecdotal evidence from activity within the shadow banking system suggests rising imbalances of some sort, and it is this very situation that has the markets so concerned, particularly since it is at odds with the tame money supply

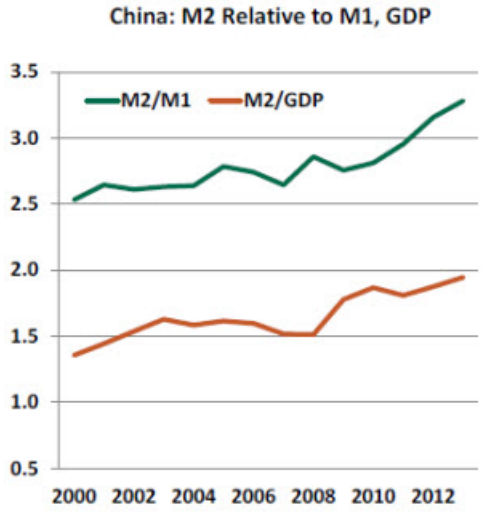
figures.

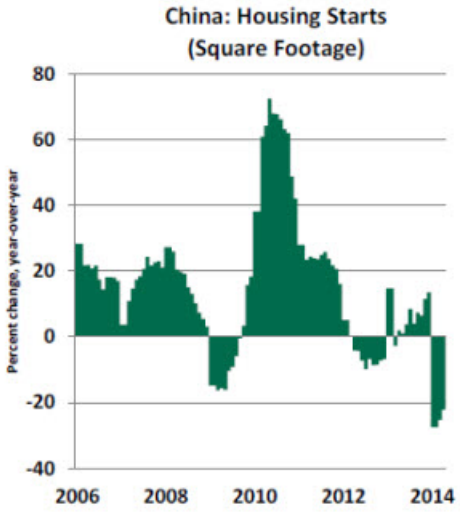
Investment in the Chinese economy has been a high-yield venture for many years, taking advantage of the lofty expectations generated from double-digit economic growth rates and ever-rising incomes. This supposedly one-way market has drawn increasing volumes of speculation, which has churned up returns in the short term but masked a gradual deterioration in fundamentals. Now that the government has acknowledged the halcyon days of double-digit growth are over, investments dependent on a stronger economy are under threat. Worse yet, speculative investments, driven by suspect sources of credit, are rapidly turning sour. These are the anecdotal concerns draining confidence from the market, yet so far they have been difficult to see in the official data. Housing start data may be weak, but does the problem solely exist in the real estate market?

Imbalances start to appear in the data when another degree of analysis is added, and more tactile evidence of a bubble can be drawn out. The first instance is within the money supply figures themselves. Before 2008, the ratio of M2 to M1 in China held to a contained band with a gradual rise that likely reflected savings rising in line with strong growth. However, the ratio took off dramatically after the 2008 global financial crisis, and even as economic growth slowed, the proportion grew markedly.

The other interesting figure is that money is growing far more rapidly than the economy as a whole. In 1993, there was one yuan in the economy for every yuan of annual economic production. That ratio grew as savings accumulated and asset prices rose, until it was 1.5 yuan of money supply per yuan of production by 2008. But over the next five years, the ratio expanded rapidly, to 1.95:1, and it continues to rise faster than fundamentals would suggest. Excessive money within an economy is often a signal that imbalances are present, and these figures suggest this might just be the case.

Evidence from the Chinese shadow banking system suggests rising imbalances.





Source: Haver Analytics

No single indicator can offer a clear insight into the future. Monetary figures are prone to reclassification and rebalancing and are only as dependable as the data sets they are compared with. But one point is clear with every indicator: the figures within the set tell a story, and that story should be consistent with other narratives in the economy.

So when the policy-makers make calming statements about a contained economic slowdown in the name of reform, but the data tell tales of excess money and discomforting ratios, the mismatch makes markets nervous. At this point, it is very hard to isolate the discrepancies and get to the underlying truth, but the reconciliation could be quite troubling.

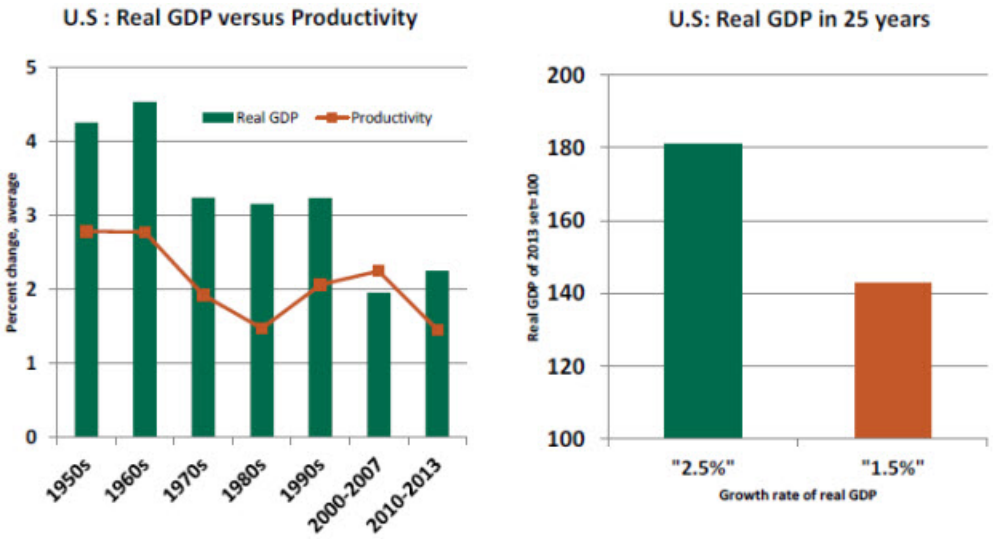
Long-Term Growth of the U.S. Economy – Pessimists versus Optimists

The Great Recession narrowed the focus of economic discussions in the United States to the near-term path of unemployment, output and inflation. While those elements are still very important, farsighted clients frequently bring up questions about the long-term growth path of the economy. The key to answering this question is productivity.

Many economic and non-economic factors influence economic growth. But over long periods of time, scientific and technological progress is the most important factor driving the development of an economy. The growth rate of productivity reflects the impact of scientific and technological developments.

An increase in productivity of workers fundamentally alters how goods are produced and drives the costs of goods and services. In the post-war period, productivity growth in the United States held around 2-3/4% in the 1950s and 1960s but

declined to below 2% in the next 25 years. There was a burst of productivity gains during 1996-2004, but productivity averaged only 1.5% during 2010-2013.



Source: Haver Analytics

Productivity growth holds the key to rising standards of living.

Technically speaking, the sum of productivity and labor force growth determines the potential growth rate of the economy. It is widely accepted that the potential growth rate of the U.S. economy is about 2.5%, with productivity growth hovering between 1-1/2% and 1-3/4% and labor force growth of roughly 0.75%.

A simple calculation illustrates the power of productivity growth. If the U.S. economy were to grow at a 2.5% pace for the next 25 years, real GDP would be 80% higher at the end of the period. However, if potential GDP growth were a whole percentage point lower (1.5%), real GDP would be only 40% higher at the end of 25 years.

If productivity fails to advance, the economic growth of the nation will be adversely affected. In this context, the future trajectory of U.S. economic growth is the subject of spirited discussions. Pessimists assert that there are several "headwinds" that will result in a decline in potential growth, while optimists have a different perspective.

Dr. Robert Gordon of Northwestern University lists four major headwinds for growth. First, the aging population and lower participation rate of prime-age adults will reduce hours worked per capita. Second, flattening of U.S. educational attainment will weigh on productivity and growth. Third, inequality reduces prospects for future income growth. Finally, high debt levels at all stages of government – local, state and federal – will adversely affect growth. Gordon estimates that the combined effects of these four forces will reduce real GDP growth significantly.

Optimists cite the innovation-led growth of the 1990s as a case that can be repeated. They point out that the digital revolution has yet to reach many walks of life and believe that an inflection point leading to faster technological change is close. Industrial robots, 3-D printing, application of big data, developments of new materials, nanotechnology and genetic engineering are examples of major innovations that have and will continue to transform life.

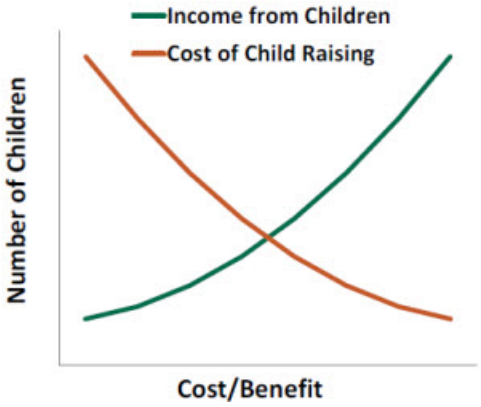
Only time will tell which one of these perspectives will win out. We can improve our chances of a more positive outcome by continuing to invest in the things that drive productivity: education, investment and infrastructure. These areas have been starved to a degree by the trend toward austerity that began in 2008. Policy-makers in the public and private sectors must find ways to increase their appetites for these essential economic nutrients.

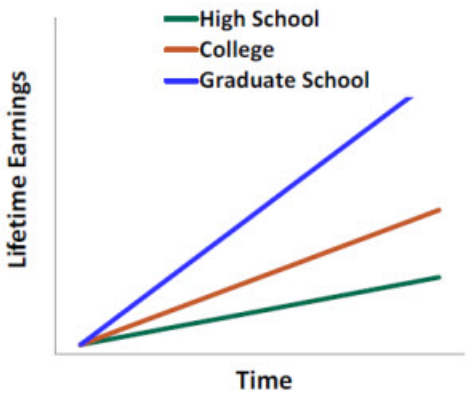
Remembering a Real World Economist

Applying economics to everyday life was once thought to be of limited value.

Initially, I struggled to grasp the relevance of economics. My initial classes focused on mythical products like widgets, and curves mapping a theoretical construct known as "utility." I couldn't see how all of those ethereal constructs mattered in the real world.

And then I was exposed to the research of Gary Becker, the Nobel Prize-winning economist who passed away earlier this month. Becker dared to use economic principles to study phenomena once thought to be outside the realm of the dismal science: marriage, child-bearing, crime and punishment, and discrimination. These were topics that I could relate to.





The displays above are illustrative examples of Becker's work. In true University-of-Chicago-style, Becker accumulated data and allowed it to lead him to conclusions. He used all manner of historical records, painstakingly collated, to study problems objectively. He was able to show that cost-benefit analysis can be used to explain criminal behavior. And childbearing decisions were based on rational calculus.

The field with which he is most closely associated is education. He wrote a number of articles on the concept of human capital: why we invest in it, who should invest in it and what the returns are over time. His insights resonate today as we debate education policy, specifically America's student debt crisis.

Economics, at its core, is the study of how people react to incentives. Our behavior is steered by evaluating the welfare we'll derive from different courses of action; by changing the costs or the benefits of these different paths, policy-makers can change outcomes. Becker's work quantified these reaction functions and proved that they were determinants in many areas of our lives.

My wife and I met as undergraduates at University of Chicago, and she was equally smitten with Becker's work. Fortunately for me, she ignored rationality and took up with me. That lapse notwithstanding, Gary Becker had a huge influence on us. We were far from alone in that regard.