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Weekly Economic Update

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The wealth of nations is not measured by the value of their GDP. That only tells the value of the production created by employing the nation's assets. The value of the assets is the nation's true wealth. That includes physical capital, like equipment, structures, and raw land -- and the human capital of skills and knowledge. Most importantly, the wealth of a nation includes its system of government as tax laws and other regulation – no matter how determined – affect the efficiency with which assets of all kinds can be utilized. Owners of assets benefit not only from the value of their production – GDP or income – but from the ability to sell them to others who feel (sometimes incorrectly) that they can employ them even more efficiently. Capital gains from the appreciated value of existing assets do not appear anywhere in the GDP accounts. Yet, income earners determine their level of consumption based not just on their current ability to produce – but on the expected value of their assets (including labor) in the future. Owners of the most desirable assets – or those who incorrectly assess their future value – can spend more than their current income through the sale of assets or by borrowing against them creating debt. At the national level, this excess of consumption is called a trade deficit.

Bottom line, it is possible for an individual or business or nation to consume more than it currently produces for a very long time as long as the future value of assets continues to appreciate faster than the rate of return that one pays borrowers, or that purchasers have to pay (or forgo) to acquire others assets. Thomas Piketty's famous book of a few years back argued that r>g – which led to an undesirable concentration of wealth, particularly through hereditary wealth transfers. He was wrong. As global trade has expanded, the spread of best practices has increased the value of many underutilized assets (particularly labor), outstripping interest payments, and encouraging those with the best assets to increase consumption. The US trade deficit (more properly, the current account deficit) has swelled as local consumers benefit from the fact that more of the wealth created around the world wishes to buy assets controlled under the US system of government. Meanwhile, the Chinese current account has shifted from a large surplus pre-Lehman to near balance now as its citizens have also increased consumption based on expectations of sustained higher income and asset growth. Both trends can -- and we believe will -- continue as the increasingly efficient allocation of global resources allows asset users to continue to expand their production and incomes faster than the interest rate demanded by lenders for giving up the income they could have used for their own consumption or investment.

Is their risk in this process? Yes, for the US and China to both overconsume someone else has to save. Until recently that global excess saving was done by China, a low income nation that experienced rapid growth and had inefficient lending markets, so consumption adjusted upward more slowly than output. Moreover, the global aging of the postwar baby boom led many well off households to save part of high middle age incomes to consume later in retirement. As these trends change it will take investment in other low income nations to creating new pools of savings -- or interest rates will need to rise to discourage consumption relative to investment. Our bet is that both happen – but that even with a rise in interest rates $r<g$ and the owners of the best assets will continue to overconsume.

We have noted in recent newsletters that there is still a lot of room for growth in China as investors move away from the east coast to lower income sectors inland. One trend that will accelerate this process is the growing inflow of foreign capital to Chinese stocks as the MSCI expands their influence in that international investment benchmark. As inland savings rise due to more efficient use of their assets, these lower income Chinese sectors will domestically fund their comrades' overconsumption on the east coast. Meanwhile, real estate values in coastal China will continue to appreciating relative to currently agricultural areas as wealth shift to the cities with the best services. Within a currency bloc, like the US, China or the Euro Zone, real estate values play the role of a local currency -- raising costs as investors flow in and squeezing profits until firms shift jobs to lower cost areas.

One critical part of this system is the relative size of assets values. The US has enormous value that it can continue to sell to the rest of the world. We often use a fanciful story about John Chisum, a good ole Tennessee boy who created one of the largest ranches in Texas. The tens of thousands of acres he controlled were largely vacant -- and valueless -- when he arrived. However, as first a blacksmith, then a baker, then a tavern owner, purchased land from him to service his employees, his wealth rose astronomically -- because even modest capital gains per acre impacted so much existing wealth. His family is still selling off land today, 150 years after his passing. Since entering the WTO in 2000, China has seen extraordinary appreciation in incomes and asset values, rising from roughly $1,500 to $10,000 in per capita income. Yet, the dollar value of per capita income rose by more in the already wealthier US, Canada, Germany, France, Spain, South Korea, Australia, Chile and almost in Poland. Over the past three years, these same countries again beat Chinese per capita income growth -- plus Japan, Italy and Taiwan. With incomes even in Shanghai at just $15,000, it will be a long time before China's best and brightest stop seeking to move their assets (and their families) to a better neighborhood – making everyone in that location richer and thus able to outspend their income.

Part of the reason for this venting about trade deficits and debt is that I attended the National Association for Business Economics' Policy conference in Washington DC this week. We heard a lot about debt and China, and I felt much of it missed the mark. Debt, as was pointed out by Paul

Krugman, should be measured against assets and debt service against income – and I reiterate that income should not be just GDP, but include an expectation about capital gains. For most countries around the world, neither debt nor debt service is currently a problem because $r<g$. Examples like Japan and Italy show things are likely to look much worse before they are a significant issue. Keep in mind both Japan and Italy saw dollar denominated increases in per capita income larger than "booming" China over the past three years despite heavy – but domestically financed -- debt loads.

We continue to believe the real information to glean from rising debt levels is that investors have become far more risk averse since Lehman, with fear and demographics both fostering a greater desire for fixed incomes rather than variable and volatile rewards for risk taking. Thus, the intrepid few who do venture into risky investments have been able to earn outsized benefits as r is far less relative to g than normal. This low risk tolerance environment leads to both slower economic growth and more concern about "income inequality" – though it is largely an issue of less than 1% versus everyone else.

On China, we feel that the widespread angst about the US losing world leadership shows an amazing lack of faith in the market system that most US economists are trained to understand. We are rarely viewed as a conservative economist (but were by some in Washington this week), but we must note that it was Thatcher and Reagan's unflagging faith in the democratic-capitalist model that led to the collapse of the Soviet Union. China's boom was driven by pro-reform leaders, like Deng Xiaoping and Zhu Rongji, and it has cooled recently under the more autocratic policies of Xi Jinping. While many in the west view Xi as all powerful, the recent policy changes in China show that he is nevertheless sensitive to the risks of political instability caused by economic weakness. China's economy is simply far too large to be managed by edict. In my fifteen year experience following their economy, I have seen massive excess investment in the real estate sector, poor agricultural policies, and inefficient external investment. Unbridled growth led to so much corruption that the Party needed to purge itself to survive destruction from within. Yet, their national potential remains so great that they still grow over 6% -- down from double digits. Imagine what growth rates they could achieve if they were as efficient as western economists would like! Those that fear the rise of China should revel in their inefficiencies.

Though I have been a long time China bull, it is critical to remember that it has been the US, Europe, Korea and even Japan which have benefitted the most from China's rise. Adam Smith preached the virtues of free trade in his appropriately timed 1776 classic tome An Inquiry into the Nature and Causes of the Wealth of Nations. He was right. The greatest risk to American, Chinese, and global growth is a retreat from that idea. The increased use of tariffs, exclusionary trade tactics, sanctions and calls to ostracize particular vendors – though hardly new – are worrisome. For US asset values to rise, allowing our consumption and the well-being it creates to exceed our own income, it is best if others enjoy greater income growth by adopting our governing principles – either through reforms in their own nations or by shifting more of their existing assets, including labor, into our markets.