FirstPoint Financial

WEEKLY MARKET THOUGHTS

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Slow Growth Is a Choice

Slow economic growth is a choice, not predetermined destiny.

In today's piece, I ask you to consider that statement. Many economists/pundits have made the case over the last few years that the developed world's GDP growth is destined to remain slow. In 2007, I wrote a theoretical piece entitled "*The Long, Hard Slog,"* which outlined my view that the United States was heading into an environment where GDP growth was going to be much slower than normal, due to high debt levels and national demographic structure. I made the case that slow growth was baked into the economic cake for a period of time.

In *The Long, Hard Slog,* I reasoned that the U.S. economy needed time to marshal the resources to pay down debt, particularly in the consumer and financial areas. Additionally, the aging of America, and the rest of the western world, was going to lead to more demands on entitlement systems, such as Medicare and Social Security, than at any time in our nation's past, adding to building government debt problems.

Other market pundits and economists have created their own versions of *The Long, Hard Slog.* The most notable version is the work of Larry Summers and Mohamed El-Erian, co-creator of PIMCO's New Normal post-global financial crisis concept. The slow growth mantra has become engrained in our nation's psyche. These days, when GDP growth exceeds 2%, politicians celebrate and economists smile. We need to understand that the average annual GDP growth rate from 1945 to 2008 was 3.3%. *This average rate includes negative growth during nine recessions.* Indeed, our national economy continues through *The Long, Hard Slog* or the *New Normal,* whatever you wish to call it.

The Roadmap

From a macroeconomic standpoint, *The Long, Hard Slog* has occurred due to four factors – two of which are dominant. Excessive use of debt, both in the private and public sectors of the economy, and the aging of the population (demographic factors) are the two factors I highlighted in *The Long, Hard Slog* theory. Let's take a look at where our country currently stands regarding these two fundamental drivers of slower economic growth.

- Private Sector Debt Structure. By most measurements, the private segment of our economy has been busy paying down debt over the last 7 years. Household debt as a percent of GDP has fallen to 72%, as compared to a peak of 96% in 2009. The debt bulge that was present on consumers' balance sheets has been lowered to levels not seen in 15 years. The percentage of take-home income needed for the average consumer to service this debt, at 10.3%, is the lowest we have seen in at least three decades. Flexibility of consumption/investment patterns has risen dramatically since the last recession. The same can be said for most of the business segment.

- Government Debt Structure. Government deficits have fallen from 10% of GDP to less than 4% over the last four years. While government debt continues to grow, the growth rate itself has been dramatically reduced. So, while the government hasn't improved its overall debt structure problem, the rate of relative debt creation has lessened over the last three years.
- Demographics. It is true – our nation is getting older. The average age of U.S. citizens is now 37 years. 13 years ago, the average age stood at 35 years. 10,000 members of the baby-boom generation celebrate their 65th birthday every day. Each year for the next 17 years, 3.6 million Americans will celebrate their 65th birthdays. These folks will wrestle with the challenge of retirement. Currently, 14% of our population is 65 years or older. That percentage will balloon to 18% of our population by 2030, when the entire baby-boom generation has crossed that age threshold. Those numbers are staggering and they represent a massive, unfunded liability on our nation's entitlement systems – Medicare and Social Security. The question is – will the individuals reaching this age actually retire and stress the economic system? A number of studies are now showing that the average American is working longer, due to either financial need or to a desire to stay in the workforce. This phenomenon is being driven by three factors:
    1. Health expectancy has risen even more than life expectancy
    2. Life expectancy continues to lengthen
    3. The physical demands of work are falling

Combined, these factors are bending the "dependency ratio" analysis.

Our nation is facing significant debt and demographic challenges. Over the last seven years, significant positive changes have occurred regarding these two factors. So, although our economy still faces The Long, Hard Slog, that Slog has become less long and less hard – or at least it should.

We have described what has been happening over the last few years. The analysis so far doesn't describe what needs to be done to continue to fix the problems that have vexed our economy since 2008, leading to very sluggish economic growth.

Continuation of Slow Growth is a Choice – Not a Predetermined Destiny

1. China pre- and post-1979: Growth during the Cultural Revolution (pre-1979) was negative. Growth, then, exploded to more than 10% per year. This massive change was primarily due to the decriminalization of entrepreneurial behavior. Additionally, the government adopted a massive infrastructure plan that represented productive investment spending (as compared to non-productive spending on wealth distribution systems). *China's leaders chose to eliminate non-productive policies and implemented pro-growth policies.*
2. Germany pre- and post-1993: In 1990, *The Economist* magazine labeled Germany "the Sick Man of Europe." At that time, Germany had no real trade surplus. Germany has shared with almost every other European nation the economic malaise of Euro sclerosis, the result of massive wealth-transfer systems and the rise of government power, resulting in inflexible labor markets. Gerhard Schroder, the then-chancellor of Germany, understood

the realities of what was wrong and began to deregulate the labor markets in 1993. Despite only partial deregulation of labor restrictions and little, if any, deregulation of product markets, over the next 20 years, Germany emerged as the Strong Man of Europe. Its growth in labor costs flattened out famously. In contrast, those of its European sister nations did not because they did not deregulate their markets. Germany's trade surplus exploded upward and its unemployment level dropped. To this day, Germany's unemployment rate is among the lowest in Europe, while its growth rate is among the highest. *Germany's leaders chose to alter non-productive policies and implemented pro-growth policies.*

3. United States pre- and post-1982: Prior to 1982 and under the leadership of Jimmy Carter, the United States was an economic giant in decline. We were intimidated by thugs in the Middle East, inflation was running rampant, and interest rates were in the teens. The demise of the American dream was far along. After Fed Chairman Volker drove down U.S. inflation and President Reagan was elected, the United States took off and by 2000 would emerge as first and foremost of all economic powers. Unemployment fell, productivity soared, fiscal and trade surpluses occurred. The country became the unchallenged global leading innovator in health care and technological capabilities. The United States led the charge to bring down one-time superpower, the USSR. Japan, a one-time rival, collapsed around 1990 due to a speculative real estate bubble. Ronald Reagan kick-started all of this in the early 1980s by deregulating the economy in a number of ways. Like him or not, his policies worked well and led to 18 years of prosperity. *Ronald Reagan and other leaders chose to alter non-productive policies in favor of pro-growth policies*.

I could cite other examples of countries where economic malaise was rampant and government policies were in place favoring government controls over free-market systems, including U.K. pre- and post-1980, Ireland pre- and post-1980, Hong Kong pre- and post-1960. When these anti-growth policies were reversed in favor of pro-market and pro-growth alternatives, strong economic growth occurred.

Regardless of whether these major changes in attitudes and government controls occurred in Asia, Europe or North America, the results of the changes have been uniform. Economic growth escalates, productivity soars, and the society benefits economically.

It is important to understand that, in all the examples cited, neither government spending nor central-bank policies drove the changes needed. Instead, government policies were changed, favoring free-market biases at the expense of state-controlled welfare-based policies.

History shows that slow economic growth is a choice – a choice of a society that favors state-controlled, welfare-based policies over policies that have historically fostered strong economic growth. Policies that focus on how much of the pie each citizen receives, rather than on the size of the pie itself, have historically led to slower overall economic growth.

To some, these statements may be painful and not particularly politically correct. Repeatedly, history shows us that when government policies limit and hinder the "animal spirits" of the private sector, economic growth and opportunities shrink for all. This has been the case in numerous societies over various time periods.

Policies that Foster Higher Productivity are Needed

For those readers who have been staying up with our pieces over the last month, you may remember my focus on economic productivity. As a refresher, there are two main drivers of real

GDP growth – the size of the labor force and the productivity of that labor force. Productivity has historically grown by 2.1% per year. Real GDP has grown by about 3.3% annually since the end of WWII.

Over the last 12 months, as of March 31, 2014, non-farm productivity has grown by 1.1%, a very anemic growth rate. As a matter of fact, productivity growth has *ranged between 0% and 2.0% annually since the "recovery" year of 2010 – a stretch of time when productivity never increased at the nation's long-term average growth rate. Why have productivity and GDP growth both been very weak over the last three to four year period? In a word, uncertainty.*

Future productivity growth is spurred by capital expenditures by today's businesses. When making those investments, business people need some ability to forecast the returns and risks. Without the ability to forecast return/risk characteristics, businesses will not invest. They will slow capital spending dramatically and wait for more clarity as to what their cost structures will look like in the future. This delay also hinders hiring. What business is willing to dramatically expand its workforce if it doesn't understand the cost structure of employing those workers in the future?

Many of the new policies coming from Washington (health care, environmental, etc.) impact the cost structure of investments and workforce levels. Without clarity, those decisions will not be made. 70% of new private-sector jobs have historically been made by small businesses. While improving over the last year, the NFIB Small Business Optimism Index currently stands at 95.0. This is the same level this index was at *during the recession of 2000-2001.* I contend that this lack of confidence is a direct reaction to the lack of clarity regarding future costs to businesses, both for labor and governmental compliance.

Decisions and policies have consequences. The consistent consequence of more intrusive government activities in businesses has been slower overall economic growth and a lower level of economic opportunity. Slow growth in reaction to high levels of governmental tinkering in the private sector has been the consistent reaction, whether in China, Europe or the United States, over various periods of time. *Policies that focus on the division of the economic "pie" do not help overall economic growth.*

Our society has made a choice between more or less governmental activities. Slow economic growth, highlighted by a low level of productivity growth and spurred by a lack of cost structure visibility, has led our country to the position where we now believe 2% overall GDP growth is acceptable.

The slow-growth economic environment, which we as a people now face, is a result of the choices we have made. Slow economic growth is a product of our own making – it isn't predetermined destiny.

We will be back next week.

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