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Second Quarter 2016 Economic Commentary

"If economists ruled the world, there would be no need for a World Trade Organization. The economist's case for free trade is essentially a unilateral case: a country serves its own interests by pursuing free trade regardless of what other countries may do.

-Paul Krugman, Nobel Laureate

The Summer Olympics just opened in Rio de Janiero this week in the midst severe recession and deep political crisis. Brazil has dealt with a high inflation rate, a fiscal deficit, and a political crisis that has evolved from a corruption crisis at the state-controlled oil company Petrobras. The President of Brazil, Dilma Rousseff, is being indicted on charges of breaking budget laws and is facing an impeachment trial that is expected to oust her from office. After a long history of deficits which led to credit defaults and currency crises in the past, Brazil has made great improvements and its implementation of hard-budget constraint legislation-the Fiscal Responsibility Law- which was applicable to all levels of government regardless of their prior economic conditions. Unfortunately, the impeachment of the Brazilian president relates to her allegedly using irregular accounting maneuvers to disguise the size of the budget deficit.

Their situation is extremely serious. Output is contracting; fiscal revenues are faltering; and the budget deficit exceeds 9% of GDP. Inflation has surpassed the double-digit mark, forcing the central bank to raise interest rates – an approach that is unsustainable, given the deepening recession and the ballooning cost of s[illegible] The situation is still Brazi[illegible] deteriorating, owing partly to China's economic slowdown, tighter international financial conditions, weak global growth, and a years-long legacy of policy mismanagement. Without market credibility, interest rates and credit spreads will remain high and hijack the fiscal-adjustment effort, forcing the economy into a downward spiral. Moreover, budgetary pressures will make it increasingly difficult for the central bank to raise short-term interest rates to fulfill its mandate of curbing excess inflation. In short, Brazil lacks fiscal and monetary credibility.

A lack of realism in the vision today costs credibility tomorrow.

Turning closer to home, as we observe the behavior of our American political economic discourse, there appears to be no line between the imaginary and the real, between implausibility and credibility.

As we wrote last quarter:

In many ways, we still seem mired in the new normal: flatter yield curves, lower rate levels, and lower levels of productivity and growth. While most countries, especially the US, have done well in the crisis management phase (I think in t[illegible]
the post[illegible]
countries find themselves in a rather unsettling situation in which expectations involve an

unusually broad range of potential outcomes and equally unusually high risks. Sadly, a once promising global response has now been replaced by inadequately coordinated national economic policies and growing frictions among countries. Extraordinary international collaboration has given way to solely domestic agendas.

We had also spoken of potential dangers in complete dependence on monetary policy to stimulate growth and its impact on trade:

A new paper by Gauti Eggertsson and Neil Mehrotra of Brown University and Larry Summers of Harvard University warns that such actions become a ze[illegible] when interest rates are near zero and central banks can no longer restore full employment. Instead, easier monetary policy works mostly by bolstering exports and dampening imports, inflicting [illegible] collateral damage [illegible]

Trade has become a centerpiece of the political debate in this country. Introductory economics courses teach the theory of comparative advantage, a concept that goes back to Adam Smith: "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it from them with some part of the produce of our own industry employed in a way in which we have some advantage. The general industry of the country, being always in proportion to the capital which employs it, will not thereby be diminished ... but only left to find out the way in which it can be employed with the greatest advantage." In fact, after World War II, the Bretton Woods agreement that established the post-war monetary system was believed "to do [illegible] the economic evils-the competitive devaluation and destructi[illegible] Most subsequent research has suggested the validity of this theory, suggesting that technological differences in countries result in difference in labor productivity and those differences in labor productivity determine the comparative advantages across different countries. In short, a country that is relatively efficient in producing steel tends to export steel. Ask an ex-steelworker in Pittsburgh, PA or Hamilton, ON (Canada's ste[illegible]-making city) about whether this theory has worked or not.

But as trade theory has advanced growth and economic improvement, as a result of trade, looks far less assured. For the first three or four decades of the Bretton Woods era, however, there was little occasion to scrutinize the benefits of trade. Most goods flows were North -to- North, between nations with relatively similar average incomes which helped subdue distributional impacts.

Views on how trade affects wages and employment turned less sanguine in the 1990s. As wage inequality rose, low-skill wages and employment fell, and manufacturing employment contracted in the U.S., globalization was seen initially as a prime suspect. Yet, after vigorous inquiry, concern about the labor-market consequences of trade receded. Economists did not find trade to have had substantial adverse distributional effects in developed economies, either for low-skill workers specifically or for import-competing factors and sectors more generally. The broad sentiment that emerged in the literature was that labor-market developments were primarily attributable to technological changes that complemented high-skill workers and reduced labor demand in manufacturing. The impact of international trade on these outcomes seemed to be modest, at best.

By the year 2000, a reasonable summary of trade theory could be outlined as:

1. Trade had not in recent decades been a major contributor to declining manufacturing employment or rising wage inequality in developed countries;

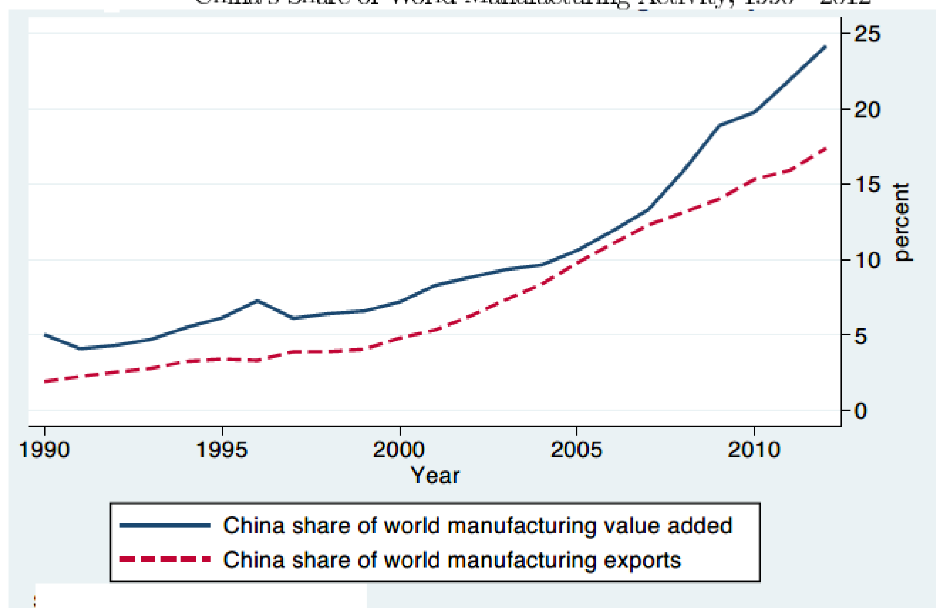
2. Workers employed in regions specializing in import-competing sectors could readily reallocate to other regions if displaced by trade; and
3. Due to the 'law of one price' for skill, any labor market impacts of trade would be felt by low-skill workers generally, not by trade-exposed workers specifically.

By this time, given the presumed fluidity of US labor markets, even in the short- or medium-run, the aggregate gains from trade in the US were believed to be positive. In short, trade was good for the economy.

The Impact of China on Trade

Just as the economics profession was reaching consensus on the consequences of trade for wages and employment, a huge shift in patterns of world trade was gaining momentum. China, for centuries an economic laggard was finally emerging as a great power, and toppling established patterns of trade accordingly. The advance of China, as we argue below, has also toppled much of the received empirical wisdom about the impact of trade on labor markets. The consensus that trade could be strongly redistributive in theory but was relatively benign in practice has not stood up well to these new developments. Nor has the belief that trade adjustment is relatively frictionless, with impacts that diffuse over large skill categories rather than being concentrated among groups of workers in trade-competing industries or locations.

We believe that this evidence calls into question the consensus of the early 2000s, and makes clear that, after the early Bretton Woods era aberration, the distributional consequences of trade are alive and well. While these results do not at all suggest that international trade is in the aggregate harmful to nations, indeed, China's unprecedented rise from widespread poverty bears testimony to trade's transformative economic power, it makes it abundantly clear that trade not only has benefits but also significant costs. These include distributional costs, which theory has long recognized, and adjustment costs, which the literature has tended to downplay. Better understanding of when and where trade is costly, and how and why it may be beneficial, are key items on the research agenda for trade and labor economists. Developing effective tools for managing and mitigating the costs of trade adjustment should be high on the agenda for policymakers and applied economists.



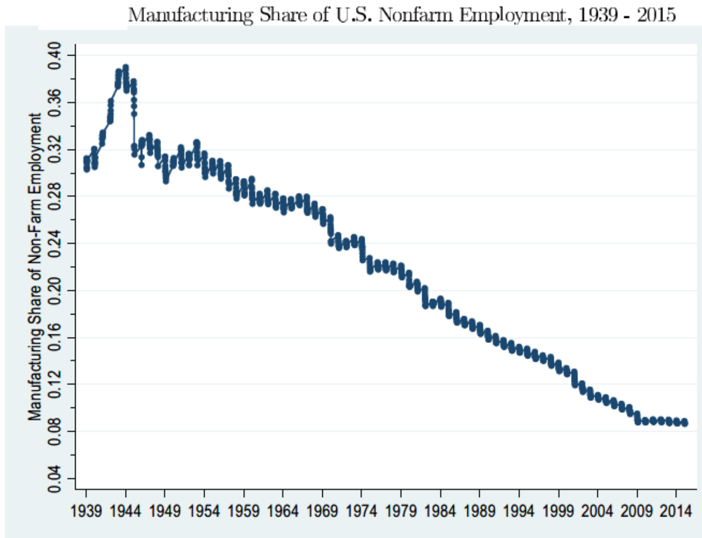
Source:World Development Indicators, World Bank

Chinese economic reform which began as an experiment involving a handful of locations on China's coast included the creation of Special Economic Zones (SEZs) that allowed foreign companies to set up factories that imported "inputs" and "outputs" from the interference of government. As reformers took greater control, China embraced global markets more fully, and pushed the number of SEZs from 20 in 1991 to 150 in 2010. According to the World Bank, inflows of foreign direct investment which had average only 0.7% of GDP during the 1980s, surged to 4,2% of GDP during the 1990s and 2000s. Production for foreign markets, as we can see in the above chart, began a spectacular ascent.

Though some politicians seem to believe that the Chinese government itself is behind the success of the Chinese manufacturing miracle, the opposite is true. Privatization, the move away from state-owned enterprises helped Chinese productivity a great deal. In the late 1990s and early 2000s, China idled many state-owned manufacturing enterprises, moving towards compliance with World Trade Organization (WTO) provisions that sanction state subsidies for domestic industries. Capital and labor were then reallocated from smaller, less productive state-owned companies to privately owned manufacturing plants, raising productivity and output in the sector. Joining the WTO also forced China to phase out requirements that had obligated many private establishments to export through state intermediaries. Such restrictions constitute barriers to export, which the WTO forbids expressly. Along with greater ease in exporting, WTO membership gave Chinese manufacturers greater access to imported intermediate which were an added boon to productivity. Prior to 2001, China's MFN (most favored nation) status in the U.S. was subject to annual reauthorization by Congress. A further consequence of China's WTO entry regards the insecurity of its earlier MFN access to the U.S. market that required annual Congressional reauthorization. Admission to the WTO removed this rule and uncertainty and encouraged Chinese firms to make long term investments in exporting to the US. Prior to achieving MFN status with the US, non-MFN tariffs averaged 37% in 1999 and changed to MFN tariffs that averaged only 3.4%.

What is the Impact on the United States?

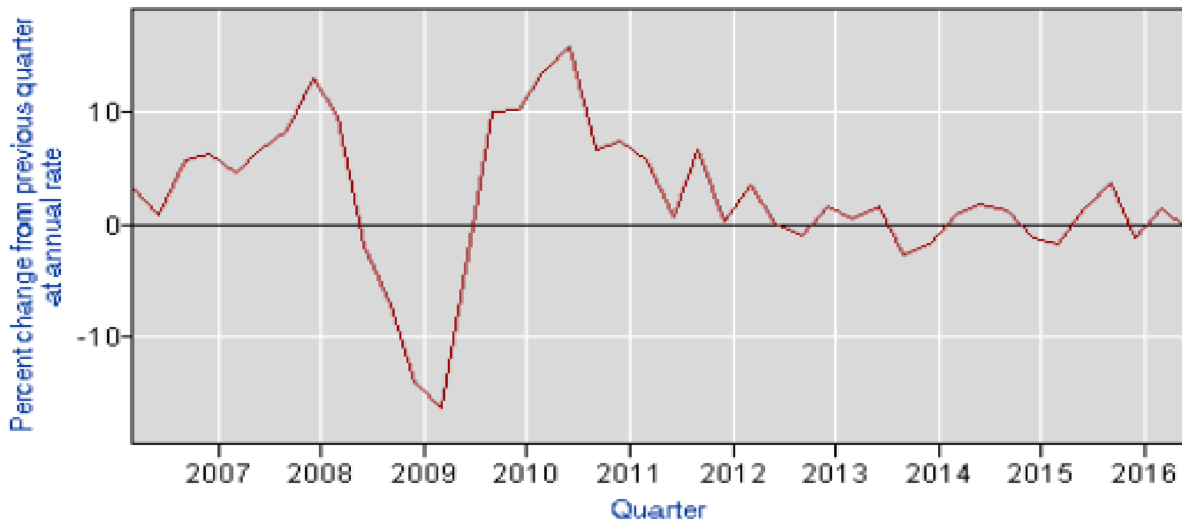
The decline in manufacturing employment relative to total employment is unfortunately, a very well established trend. Certainly, it is not clear that this entire trend is attributable to China.



Source: FRED Database- Federal Reserve Bank of St. Louis

Productivity improvements in manufacturing productivity have gone nowhere in recent years:

Manufacturing Productivity



Source: Bureau of Labor Statistics

We haven't seen such poor productivity numbers since the late 1970s, when high inflation, a weak dollar, and foreign policy disasters created a multi-year malaise. We have a big productivity problem, and it stems from a lack of business investment, pervasive risk aversion, crushing regulatory burdens, and a general anti-business, anti-growth sentiment emanating from Washington and the campaigns. As well, a lack of capital investment has contributed to the reduction in the amount of GDP contribution by manufacturing. In the period from 1987 to

2015, the contribution of capital intensity to labor productivity represented about 40% of the improvement. But in recent years, due to a lack of spending, this has dropped to around 15%.

The impact of trade goes well beyond the trade impacted industry. Some regions of the country have greater vulnerability to imports simply because they are more specialized in manufacturing overall. For workers with less than a college education, increased trade exposure also predicts significant reductions in employment in non-manufacturing industries because of negative local demand spillovers. Largely because US labor markets are not as fluid and flexible as had been believed, reallocation or mobility of labor plays little role in responding to trade shocks.

Recent studies have measured the impact of NAFTA tariff changes on wages in the US. Wage growth for high-school dropouts employed in the industries that were initially the most protected, and therefore subject to the largest tariff declines, was 17 percentage points lower than for comparable workers employed in initially unprotected industries. And high-school dropouts employed in locations that were initially the most specialized in industries vulnerable to NAFTA had a wage growth that was 8 percentage points lower than for similarly educated workers in locations with few protected industries. Surprisingly, the next most affected labor-market group is workers with some college education. NAFTA wage impacts for high-school educated workers are comparatively modest and for the college-educated are effectively zero. When manufacturing contracts, workers who have lost their jobs or suffered declines in their earnings reduce their spending on goods and services. The contraction in demand is multiplied throughout the economy, depressing consumption and investment. Helping offset these negative aggregate demand effects, workers who exit manufacturing may take up jobs in the service sector or elsewhere in the economy, replacing some of the earnings lost in trade-exposed industries.

Are there any positive employment effects from US trade with China that we are ignoring? About the only mechanism that we see is that increased competition in final goods markets alters investments in innovation. For example, there is evidence that European apparel and textile firms that faced greater competition from China following the elimination of quotas under the Multi-Fiber Arrangement produced more patents, had higher productivity growth, and boosted purchases of new technology. Although intensified product-market competition may raise the incentive for innovation, it can just as easily work in the opposite direction. The aggregate impact of Chinese competition on U.S. innovation remains unknown.

Labor quality growth captures the upgrading of the labor force through higher educational attainment and greater experience. While much attention has been devoted to the aging of the labor force and the ongoing retirement of the baby boomers, the looming plateau in educational attainment has been overlooked. Average levels of educational attainment of the people entering the labor force will remain high, but will no longer continue to rise. Growing educational attainment will gradually disappear as a source of U.S. economic growth.

Are the lower participation rates of the less-educated workers a "new normal
some time? Or, will the continuing economic recovery enable these workers to resume the higher rates of participation that preceded the Great Recession? The answers to these questions are critical to the future growth of the U. S. economy. The predominant role of investment in plant, equipment, and software, and growth of labor input in U.S. economic growth is crucial to the formulation of economic policy. During the prolonged recovery from the Great Recession of 2007-2009, economic policy should focus on reviving investment and re-establishing the pre-recession participation rates of the labor force.

Are We Measuring GDP Correctly?

Recent years have seen a rapid emergence of disruptive technologies with new forms of intermediation, service provision and consumption, with digitalization being a common characteristic. These include new platforms that facilitate peer-to-peer transactions, such as AirBnB and Uber, new activities such as crowd sourc
self-employed' and prevalence of 'free' media service
Against a backdrop of slowing rates of measured productivity growth, this has raised questions about the conceptual basis of GDP, and whether current compilation methods are adequate.

Despite its novelty, giving rise to a new lexicon
important to recognize that the underlying transactions that are the bread and butter of the sharing economy are in and of themselves not new. Households have long engaged in peer-to-peer transactions such as the provision of dwelling rental services, the provision of taxi services (often unlicensed), and the sale of second hand (and indeed new) goods (e.g. via garage sales and classified adverts). And GDP, at least conceptually, captures all of the related transactions and value-added created. What is differe onomy is the scale of these transactions. For instance, AirBnB now has a market capitalization close to that of Hilton Worldwide, and larger than that of other global hotel companies such as Marriott. Many of these developments are driven by the explosion in computing power and access to broadband that has facilitated consumer access.

Much of our traditional measurement of an economy has become problematic and challenged by the scale of the digital economy. It is becoming increasingly evident that GDP is not as good a measure of welfare or consumer "surplus" as it once
GDP with other indicators that capture well-being.

So are we responding to the wrong data as far as economic growth? The souring of public opinion re global trade, even though the Trans-Pacific Partnership (TPP) is or
signature second-term achievements has caused Hillary Clinton to withdraw her support. Donald Trump's anger at gl ry driver to his economic plank.

We continue to get very mixed signals about the US economy. Hearkening back to the Olympics, the Olympic motto is "Faster, Hig Recent labor statistics lived up to that motto, with the economy adding 255,000 new jobs for July following June's 292,00 The ris
unemployment rate remains at 4.9%, which suggests that payroll growth at current levels cannot persist for much longer without generating lots of tightness, and wage growth, in labor markets. And indeed, measures of wage growth, which long seemed immune to better news on hiring, are showing signs of life. Though average hourly earnings were up a disappointing 2.6% over last year, they rose at a 3.8% annual pace from June to July. Did they decline and then grow?

One good piece of news is that the growth of the labor force is picking up, albeit slowly. More and more people are being enticed to either work or look for work. But despite the recent improvement, the labor force is still over 6% below its long-term trend (i.e., about 10.7 million workers have "disappeared"). Baby boomers retiring accounts for a portion of that shortfall, but there must be other factors at work as well: very high marginal tax rates, heavy regulatory burdens, and maybe even the recent wave of minimum-wage hikes. When unskilled labor becomes artificially expensive, businesses have a strong incentive to replace labor with robots.

In the year ended last June, the federal government sent out checks totaling almost $2.8 trillion to people for not working. That represents about 20% of disposable income (and a

whopping 73% of total federal spending), and that is very nearly a record high. When so much is paid to so many for doing things other than working it's bound to have a perverse impact on the jobs market. The only good news here is that the growth of transfer payments appears to no longer be exceeding the growth of incomes—we're at a plateau of sorts. At the same time, the labor force participation rate appears to have bottomed. On the margin, in other words, the damage done by transfer payments is not getting worse. But we're going to have to tackle the entitlements problem in a big way, or else transfer payments relative to incomes will continue to climb, the labor force will continue to grow in a tepid fashion, and the federal budget deficit will rise to unsustainable levels. We're not there yet, but this threat looms large on the horizon.

Other economic indicators are less robust. Retail sales have been disappointing, particularly for brick and mortar traditional retailers. The University of Michigan index of consumer sentiment rose slightly in July versus June but remains about 1.6% below its level of a year ago. Consumer expectations have plummeted by almost 4% year-over-year. For the second quarter, US industrial production fell at an annual rate of 1.0%, its third consecutive quarterly decline. Capacity utilization for the industrial sector was 75.4%, a rate that is 4.6 percentage points below its long-run average. In Europe, we have also seem improvement in industrial production by a lesser rate, 0.4% which unfortunately is down from the somewhat robust 3.4% rate Europe showed in January of this year.

Concluding Thoughts

The economy is still stuck in slow-motion: it's been the weakest recovery ever for the past seven years: a mere 2.1% annualized. The first half of this year was even weaker than that (1%), but it's the nature of GDP numbers to be volatile; as with the payroll employment data, you have to look at the trends over months and years to get an approximate idea as to what is going on. Monthly, quarterly, and annual data are routinely revised after the fact, and sometimes significantly. It's amazing that the government statisticians can even come close to measuring all the activity inside an $18 trillion economy.

Source: Bureau of Economic Analysis, scottgranis.blogspot.com

The data we can trust, however—tax receipts, market-based prices, corporate profits, unemployment claims—are in general agreement with the GDP stats, as I've been noting off and on for the past several months. The economy is most likely still growing at a sub-par pace of 2% or so, as it has on average since 2009 (see chart above). Just because it's growing slowly is no reason to worry that a recession is imminent. The analogy that says a slow-growing economy is like an airplane approaching stall speed is flawed. Indeed, recessions typically follow periods of

excesses—soaring home prices, rising inflation, widespread optimism—rather than periods dominated by risk aversion such as we have today. Risk aversion can still be found in abundance: just look at the extremely low level of Treasury yields, and the lack of business investment despite strong corporate profits.

The economy's historic ability to grow by a little more than 3% per year on average for over four decades suddenly vanished beginning in 2009. For the first time in post-war history, the economy failed to recover to its former growth path following the 2008-09 recession, and it has managed to grow only 2.1% since then. Seven years of slow growth following a big recession have left the economy about $3 trillion smaller than it could have been. We're missing out on approximately $3 trillion per year in income, and that's in Trump-speak "yuuge". Put another way, the average family could have been earning about 18% more this year if the economy had recovered in typical fashion, and of course there would have been many more people working. The $3 trillion GDP shortfall is the easiest way to understand the widespread level of discontent in the U.S. today.

One of the best things about the past two decades is the strength of corporate profits. From 1958 through the mid-90s after-tax corporate profits averaged about 5% of GDP. But while corporations have generated about $1.5 trillion in after-tax profits on average over the past seven years (about $10.5 trillion in total), federal government debt held by the public (i.e., net borrowing) has increased by about $6.8 trillion. That means that, in effect, our government has borrowed 2 out of every 3 dollars of corporate profits for the past seven years, and then handed the money out to favored constituencies. In return, the government has enjoyed the lowest borrowing costs in history, but the economy has squandered much of its scarce resources. We've plowed two-thirds of the profits of the most valuable companies in the world into (mostly) transfer payments that have generated zero net growth. This recovery has seen a colossal waste of money.

Private Fixed Investment tells the same story. Relative to GDP, fixed investment (structures, equipment, and software that are used in the production of goods and service) has declined by almost 20% since 2000. The go-go growth of the mid-80s and the late 90s were driven by strong investment. Today's weak investment climate has given us a miserably weak economy. It's not surprising.

Ultimately, the solution to our weak growth is to enact policy that will encourage investment, work, and risk-taking. Reduced regulatory burdens would be helpful but the country needs greater confidence that conditions will remain favorable down the road, and actually implemented by a do-nothing Congress.

As we said last time, slow growth, financial instability and capital market uncertainty will have further economic consequences as well as potentially political ones. We are in an unstable situation where there are many things that can go wrong and fewer that can go right. Needless to say, mitigating secular stagnation is of paramount importance in reigniting growth and capital markets' returns.

As always, thank you for your confidence and trust!

Richard H. Konrad, CFA, CFP®
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