Armchair Economics

Perspectives from an economic everyman

The Growth Ghost

December 2011

It seems that most everyone in the finance world I talk to these days has become increasingly concerned over our economic situation. The mood of people who deal with money has become quite unsettled. This contrasts greatly from just a year ago, after the shock and awe of government regulatory, fiscal and monetary stimulus seemed to have righted our economic ship.

Our sort of back to normal economy continues to be dominated by financial services. As money goes, so goes economy. Money reduces the friction in commerce. There is no ability to settle accounts easily without it. How could any iDevice be produced in the 20 some countries that drive its production without a well functioning monetary system?

It should be no surprise that the financial services industry is front and center to our global economy. It is the industry that must be running smoothly for global commerce to provide the cornucopia of products we enjoy today. Technology has provided us with an amazing abundance of consumption choices and it has lifted economies around the world. But only with a stable monetary system can the smorgasbord of consumption choices and the global rising-tide-lifts-all-ships economy continue.

This is why the Euro situation is so dramatic. As the Armchair has suggested before, should one link in the bicycle chain break, the whole bicycle will likely stop working. What would economy look like if there was no ability to peddle? Certainly it would still exist, but just consider how far and how fast one can go on a bicycle without that chain working. And as more and more people have started to understand, one link break is likely followed by many more. Our massive interconnectedness has made us interdependent.

This is what panics Europe and why patching up the Greek economy is no longer their primary focus. Europe has reached the point where it needs to become much more like the United States of Germany and less like the economic trade zone of Europe. Countries are going to lose their sovereignty, or not. And if not, if they choose to remain independent nations, then the bicycle chain of finance, our monetary system, will likely fall apart. And there may be no easy way to put those pieces back together, certainly not quickly.

Evidence of our fear can be seen in the latest announcement that G20 nations are prepared to increase IMF funding. Let's see…broke countries will give the IMF more money so they can lend it back to the broke countries. How does that work? Sure, the G20 is more than just Europe, the United States and Japan, but these three economic regions dominate the global economy, so their ultimate G20 contribution to the IMF will dominate as well.

One of my insightful associates recently asked, "Why can't we kick the can down the road for 20 years, just like Japan?" That's certainly a worthy question to ponder. Why can't we? The Japanese have kept their ship from sinking, business there continues as usual, or at least somewhat usual. The Japanese ship though has become extremely burdened with more and more debt. Today Japan leads the world in debt to GDP at over 200%.

Can we follow this path in Europe and the United States? The Armchair's first response is that we've already been kicking the can for 10 years, since the 2001 recession, so maybe we're half way through this economic malaise. But then we have to remember that even after a 20-year exercise in Japan, light has yet to be seen at the end of their dark economic tunnel.

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The power of self-preservation is surely the most powerful human influence, so it seems reasonable that we will do whatever it takes to keep this game going. We will continue to kick the can down the road as far as possible. It is only human nature to do so. But this is only a game of survival, focused on living just another day. Why are we so focused on debt and survival, and not growth and prosperity? The answer to this question is also the reason why the road we are kicking cans down likely has a dead end. Growth is now a ghost.

Beyond the mumbo jumbo policy we get out of government, there are ONLY three catalysts for economic growth.

The first catalyst is population growth. As population grows, so does the need for more stuff. And the more stuff people need to purchase, the more an economy grows. So long as the rules of engagement are favorable to society as a whole, population growth can create a virtuous economic growth cycle. This has been the story in the developed world since the Industrial Revolution.

But now, look around and we see population growth has at best slowed to a crawl in the developed economies. Europe and Japan have begun their demographic decline. The United States continues to grow because of immigration, but will immigrants continue to come if unemployment is stuck at a new higher plateau? There is no land of opportunity if there is no opportunity.

As economic opportunity contracts, we can also expect the U.S. birth rate to do so as well. Why have children if you are not sure they will have a prosperous future? This is why the birth rates in both Japan and Europe are now contracting. The United States seems set to follow. Overall there appears no way for population growth to be a catalyst for economic growth in the developed economies.

What about population growth occurring in other parts the world? Can that population growth support economic growth in developed countries? This is certainly a possibility, but those growing parts of the world must have rules of engagement that are favorable to society as a whole, and this does not seem to be the case in the fastest growing population centers. Even if it were, the expansion of today's Western lifestyle and consumption rates to more people and more economies will further strain natural resources and the environment, causing costs to escalate. And escalating costs are the last thing over-indebted developed economies need.

Population growth as a catalyst for economic growth just might have reached a limit.

The second catalyst of economic growth is productivity growth. As we reduce production costs, prices for goods fall too. As things become more affordable, more people can buy them. Increased demand means an increase in production and employment, which further increases demand. Here again we have a virtuous growth cycle.

A simple example of productivity growth can be found in agriculture. From an economic history perspective, not so long ago most everyone was working in agriculture. But since the Industrial Revolution, the amount of agricultural output per input of labor has increased dramatically. Who do you know that works on a farm?

We increased productivity in agriculture by creating more machines that replaced agrarian labor. It was production labor making those machines. So labor naturally found a home away from the farm, making stuff that increased the productivity of the farm. This inspired virtuous economic growth.

But now productivity growth is focused on increasing the output of production per unit of labor input. We seem to have tipped into a period of reducing labor in production like we previously did in agriculture. So now where does labor go?

The obvious answer is that just as before, when it transitioned from agriculture to production, labor will now transition from production to the information economy. But here's the rub: Computers manage information much faster and much more accurately than people do. So, while productivity growth was once the catalyst for economic growth, today it is leading to the destruction of production labor, with nowhere for displaced labor to go next. And yet, it is the wages of labor that drive all economy.

The conclusion seems to be that productivity growth is no longer the catalyst it once was. Instead it now seems to be working against economic growth instead of for it.

The third catalyst for economic growth is the liberalization of capital. The easiest way to understand this concept is to look at debt. The more we can borrow, the more we can spend. If we reduce the mandatory down payment on a home from twenty percent to five percent, we have more capital to spend on other stuff. And if we increase the number of people who can borrow money, then of course more stuff can be purchased. The more stuff that gets purchased, the more the economy grows.

Here again a virtuous growth cycle is created as capital becomes more and more liberated. As we have seen over the last forty years, that liberation has spurred economic growth. It now seems, though, that we have reached the end of this train, at least in Japan, Europe and the United States. The liberalization of capital in China continues, but then the construction of see-through buildings and empty cities just looks like another bubble bound to burst.

If anything, it seems that once population growth and productivity growth mature, it is the liberalization of capital that then takes over as the economic growth engine. But now we seem to have reached a point where all future asset values and cash flows have been brought to the present by debt.

So here we are today, a developed economy world swimming in debt, capable only of kicking the can down the road because there are no more organic economic growth drivers. We don't have growing populations. We now have productivity growth destroying labor, and yet it is wages that drive consumption. And we've brought to the present all future projected economic asset value and cash flows through capital liberalization.

Given the almost complete lack of growth catalysts, there seems no way the developed world can ever pay back its debt, much less keep their social promises. This road we are kicking the can down has a dead end. Maybe we've reached the end of the Industrial Revolution period. What comes next we don't know, but fear of change and the power of self-preservation will keep this game going for as long as possible. But growth as we have known it since the Industrial Revolution began is now a ghost.

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