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Challenges For The Big Two

The outlook for freedom and growth in the U.S. and in China.

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In our January column (“A Sensible Strategy”) we suggested gradually increasing allocations to emerging markets. We cautioned, though, that not all emerging markets are created equal. “Transparency is always a concern, and whether citizens are increasingly free is probably the most critical variable to evaluate and monitor.”

This month we’ll elaborate on that most critical variable—the condition of personal freedom, which is always and everywhere the sine qua non of economic progress. Take, for example, the U.S., the world’s largest economy, and China, its fastest growing.

The Enigma

One of the principles of classical economics is that a society’s standard of living improves when its members are free to pursue a better life for themselves and their families by working hard, saving, taking economic risks and reaping the rewards of their efforts. A corollary to this principle is that when the motivation for these efforts is diminished by outside forces (usually some form of government control or taxation) then the whole economy languishes.

In the United States, personal economic freedom has always been secured by a democratic form of government and a rule of law designed to protect the rights of workers and investors. This combination of political and economic freedom is widely credited with the unprecedented prosperity achieved in America and in nations that have adopted a similar construct. More repressive social models have never produced a steadily rising standard of living for the general population … think Cuba, much of Africa and the Middle East, North Korea, Venezuela, the USSR, and communist China. But, wait a minute …

In 2009, the economy of the United States, the guardian of Western democracy and champion of free-market capitalism, shrank by a record 2.6% despite massive credit injections by the federal government. In that same year, China’s avowedly Marxist economy, despite the contraction of its major export customer, grew by a solid 8.7%, continuing 25 years of growth in which it has averaged over 9% a year, a pace unheard of in the modern free-market West. This disparity raises some questions: Is it that personal freedom is on the wane in America or that China is experiencing an expansion of personal freedom? Or, if it’s neither, is it that the freedom-growth principle is an inadequate explanation of economic progress?

We saw in the 20th century the boundless creativity of the human spirit. Unconstrained by cultural and institutional prohibitions, and free to enjoy the fruits of their efforts, human beings have multiplied the productivity of their farms, made air travel commonplace, practically eradicated polio and malaria, and distributed one billion 2-inch digital screens with free access to the libraries of the world. Personal freedom is critical to the exercise of our inherent creativity and powers of adaptation.

Freedom And Growth In America

Jamestown and Plymouth Colony were settled in the early 1600s by small numbers of people seeking economic opportunity and religious freedom; their expenses were underwritten by investors hoping to profit by developing trade with the New World (which is olde English for “emerging markets.”)

Efforts by the English crown to tax the colonists in the late 1700s were regarded as a power grab and violation of what Americans believed was their right to be taxed only by their own representatives. The Boston Tea Party and other organized protests coalesced in the First Continental Congress in Philadelphia (1774). One year later, a Minutemen confrontation with the “Red Coats” launched the American Revolution, and the birth of the freest country in the history of the world. Today, America’s 5% of world population accounts for nearly a quarter of global GDP.

Much has changed in the United States in the last 60 years. The national pride that unified citizens during World War II has faded into a polarizing disagreement about the American Dream and the role of government. But another significant change is that our savings instinct has all but disappeared. Since 1965, savings in the U.S. has steadily declined from 12.5% of GDP each year, to negative 2.5%.

Even as we have saved less, we have borrowed more. Total debt in the United States (both private and public) equals 370% of GDP. In 1985 it was half that. Public and private U.S. debt in the last decade has been growing six times faster than GDP, and this will have consequences. The cost of servicing it will limit our economic freedom and restrict our growth until we correct the imbalance.

Society has long understood that debt is a constraint on freedom. Proverbs 22:7 says, “The borrower is the slave of the lender.”

Today, we are caught up in a vigorous national debate about the influence of growing public debt on our freedom and future prosperity, and the proper role of government in coping with the situation. Not surprisingly, much of the polemic is politically charged; modern Tea Parties are almost an echo of our 18th century struggle with England.

Most analysts see three possible roads back to financial equilibrium in the Western world. We can begin a long period of restrained growth and gradually reduce our loan obligations. We can balance the federal budget and let the markets sort out the credit issues. Or we can make present debts easier to repay by fostering higher inflation.

Reflation is a de facto tax on the poor and those living on fixed incomes. It punishes savers and lenders and favors debtors. Yet because it is the most politically expedient, it’s our most likely policy direction. (The IMF actually recommends a 4% inflation target in developed countries.)

However the policy debate unfolds, this is about our economic freedom, not about our political freedom. And this is a distinction with merit. Our citizens themselves have the power to determine the direction of government policy. We can still replace the policymakers at the ballot box when we think it is appropriate. But that is not the case in China.

Freedom And Growth In China

China’s written history dates back 3,700 years, but her culture, literature and philosophy trace back to the feudal Zhou Dynasty (1045-256 B.C.) that gave way to the Chinese empires. Over the years, the emperors developed sprawling bureaucratic systems that allowed them to control vast territories whose populations sprang from a number of different Asian peoples. Fast-forwarding 2,000 years, today those bureaucracies are the purview of the Chinese Communist Party, whose members total just 5% of China’s 1.3 billion citizens.

In 1949, Mao Zedong proclaimed the People’s Republic of China from atop the Gate of Heavenly Peace (“Tiananmen.”) He believed that socialism would triumph over all other ideologies, and began his rule with the execution of landlords and the redistribution of land to peasants. Mao was avowedly Marxist in his belief that workers—and not the owners of land or capital—were entitled to “surplus labor” or what capitalists would ordinarily refer to as profits. Though compromises were made in subsequent regimes, this important communist principle has never been disavowed.

In 1980, Deng Xiaoping emerged as the party’s leader. He was convinced that the country needed a new emphasis, one that was Marxist but less hostile to the country’s traditions. He promoted “socialism with Chinese characteristics.” To jump-start the economy, he reopened China to foreign investment and global markets and he permitted limited private competition in special economic zones allowed to run as a capitalist system within the communist state.

Political tensions continued between “conservatives” who were unhappy with Deng’s accommodation of Western materialism, and “liberals” who protested the party’s totalitarian leadership. In 1989, the year a number of other communist governments around the world collapsed, there were weeks of demonstrations by supporters of democratic reform in Tiananmen Square in Beijing. Deng authorized a military response and several thousands were gunned down.

Economic liberalization expanded under Jiang Zemin and China’s growth rate had picked up by the mid-1990’s. China gained membership in the World Trade Organization, and this year it will displace Japan as the world’s second-largest national economy.

If China’s economic-political model were more like our own, it would be easy to postulate that it will sustain or even hasten its amazing growth pace. After all, the Chinese need not patiently await the development of the internal combustion engine, telephones, plastics, robotic assembly lines, fertilizers, air and space travel, modern banking, nuclear power, the globalization of commerce, the microchip and miracle drugs that have evolved in the West during the past 200 years. All that and more is available every morning right on China’s well-guarded doorstep.

But China's model is not like ours; it's far more Hobbesian than Jeffersonian. The Communist Party is sovereign and adheres to the Marxist concept that all profits belong to the state for the benefit of the working class. But Google has recently discovered firsthand what the protesters at Tiananmen learned the hard way: There is a dark side to absolute power.

The party's Politburo remains openly concerned about controlling the message and minimizing dissent. Officially, the Tiananmen Square massacre never happened. There is no political freedom, a poignant distinction between China and the capitalist West. Yet China has enjoyed increased prosperity in the past 25 years. To the degree that citizens benefit from these economic gains, one could conclude that there's been an increase in economic freedom. Even though workers typically earn about 3% of what is normal in developed countries, by the millions they choose factory work over subsistence farming.

The American experience of building a democratic society from scratch will never be duplicated. But China's economic growth has to make you wonder whether another people with a different history and a different model might evolve in such a way as to liberate the creativity and decency of the human spirit while protecting the citizenry from power's oppressive tendencies. Is capitalism's view too narrow?

For years, traditional economists have forecast the implosion of China's centrally planned economy because it ignores "market signals" such as price, consumer demand and interest rates that help allocate capital most productively. Yet the country's steady growth persists. The outside world does not know by what complex process China's economic decisions are actually made, and that should probably bother us as investors.

Transparency is a big issue. State-controlled bank balance sheets are widely disbelieved. And we know that China's accounting is different. For example, when they authorize $100 billion for an infrastructure project, it immediately becomes part of reported GDP. We also know that huge capital allocations have gone toward what capitalists would deem enormously wasteful: The largest mall in the world is practically empty after five years, as is a brand new, upscale city built to accommodate a million residents.

Outlook And Investment Response

America faces two clear challenges to economic growth: too much debt and low-cost imports. We think debt will be managed down but that interest rates will rise and GDP growth will be grudging for some years.

Our investment policy response at Financial Advantage follows this course:

- Cash reserves kept at a minimum (5%) until interest rates rise.
- Diversified income securities (40%), emphasizing high quality and shorter durations.
- Growth opportunities (40%) emphasizing the stocks of U.S. businesses with very strong balance sheets, essential products and services, overseas growth and competitive advantages that will allow them to gain share against weaker companies in a flattish economy.
- Tactical investments (15%) to supplement stock and bond holdings, for example, gold, inverse ETFs, paired trades, special situations and momentum trades.

We're avoiding Chinese shares. The consensus is that there will be uninterrupted growth in China, but that ignores two big risks: the weakening of demand for its exports (due to stagnation and protectionism in the West) and possible growing unrest at home. We will gradually increase our modest (5%) emerging market investments to take advantage of weaknesses but we prefer countries whose citizens have more influence in the political process.