Economic Growth. China, India and US. Taking Stock.

Economic growth expectations have risen in the past few months on the back of

- a real improvement in economic data,
- a recovery in commodity prices,
- strong equity and credit markets,
- expectations of fiscal stimulus under the new Trump Administration.

In China, growth in 2016 was bolstered by the reorganization of manufacturing, which is really a global phenomenon, but even more so by fiscal and monetary stimulus on a significant scale.

One should, however, consider what is sustainable and what is not, and what is short term expedient and what is long term structurally sound.

China's economy is fast approaching a size and wealth which makes over 6% annual growth difficult to sustain. Efforts to maintain that level of growth can lead to imbalances and instability. The gains from globalization and integration are largely over and future growth will be dependent on the demographics, resources and know how of the Chinese economy. Further gains can be had by the liberalization of the economy and financial markets, but even these will eventually reach their limits and further growth will require innovation and improvements in know how.

Chinese economic, and indeed social policy, have always prioritized stability and continuity. It is this quest for stability that led Chinese policy to become highly expansionary in 2015/2016 to address the slowing economy and stock market declines in 2015. China's command economy affords it more tools than the conventional or even unconventional tools that Western developed countries have at their disposal. Instead of wide ranging quantitative easing, the PBOC engaged in targeted credit provision in a series of open market operations as well as targeted operations, effectively repo lending to specific sectors and institutions, on a large scale. China's desire to maintain a target level of growth led it to lean on the central crutch of infrastructure and construction. This has fueled a commodity recovery and a housing boom in China.

In early 2017, however, recognizing the scale and speed of credit creation in the economy, Chinese authorities are reining in credit, raising its cost and rationing its availability. It remains to be seen if they will be able to contain the risk without slowing the economy too severely.

China's experience is instructive as it illustrates the difficulty facing central banks trying to operate an economy at a rate of growth higher than that implied by its endowments of labour, resources, capital and technology. Is it sustainable or does growth slow below prior natural rates once stimulus is withdrawn?

For now, current data suggests that China has stabilized growth at a reasonably high rate, has reorganized its manufacturing sector to the new de-globalized reality and is in risk management mode. As markets are more sensitive to rates of change than levels, asset markets are likely to take an optimistic view.

The risks to the prognosis are that the cold trade war turns hot under the Trump administration, that a political crisis in Europe precipitates contagion, that there is a growth slump from policy mistakes, or that there are geopolitical disruptions closer to home such as in the South China Sea.

Even excepting such exogenous events, the gains in manufacturing will not fully compensate from the reduction in world trade, and there are no signs that trade relations globally are warming and it is likely that the current trajectory of the PBOC's policies, even as touted as risk management, will be a brake on growth.

More immediately, the impact on asset markets is likely to be adverse given their sensitivity to policy and financial conditions over fundamentals.

India's recent economic slowdown is to a certain extent self inflicted. In November 2016 a mass demonetization of large denomination currency notes led to 85% of notes in circulation being taken out of circulation. The immediate impact on an economy with a large proportion of informal participation has been significant. The aim of the demonetization was ostensibly to root out the black economy. The recent implementation of GST as part of a wide ranging tax reform program is certainly made more effective by bringing the informal economy under the regulated banking system.

While the immediate impact of the demonetization has been serious for certain industries which traditionally have relied on cash for transactions, the coincident rise in point of sale card usage is indicative of an overlooked dimension.

As money is transferred out of the physical realm to the fractional reserve system, the money supply is almost surely to surge. The RBI initially hiked the reserve ratio to 100% before later relaxing it. Some of the cash deposited will leak out of the system again once the new 500 INR and 2000 INR notes are circulated, but for many, the forced experience with banking will translate into future comfort with banking infrastructure.

It is likely that the increase in money supply will be significant and could be inflationary. The RBI will have to be vigilant and will likely have to raise rates or reserve ratios to manage the increased money base.

India is the most interesting economy in Asia not least because its potential is great, and slow to be realized because of political and policy frictions. It is an economy struggling in the right direction contrasted with some other economies that rush in the wrong direction.

The US stock and credit markets are making an unequivocal statement about the policies of the Trump administration. Valuations are getting richer and credit spreads are getting thinner and asset prices are grinding higher on lower volatility almost daily.

Trump’s fiscal and trade policy are aimed at addressing what the President has identified as areas of weakness and potential improvement in the US economy. While the problems are properly identified, solutions are not easy to find and the ones proposed may not be as effective or without side effects as advertised.

A fiscal stimulus plan worth 4 trillion USD over 10 years (some 2.3% of GDP) is significant, however, House Republicans will be interested in how this will be financed, and the potential inflationary aspects of the plan could encourage the Fed to raise rates more aggressively, precipitating a slowdown.

The tax cuts will be highly regressive and distribute income towards high earners and asset owners reducing the velocity of circulation and lowering multiplier effects. Savings rates will likely rise.

Interest rates are already rising driven by an expected deterioration in federal debt to GDP, the current account, the budget deficit and higher inflation expectations. Financial conditions have therefore tightened, despite the tightening of credit spreads. SMEs and lower quality issuers tend to lend at floating rates which are feeling the immediate impact of higher rates.

The Trump administration’s policies are likely to lift US growth 2017 and 2018 but the longer term impact is likely to be reversed or diluted. Debt financed fiscal policy is not immune to the fact that borrowing is a temporal transfer of wealth from one time period to the next. It is only to be undertaken if the investment in the current period generates sufficient returns to more than compensate for the future repayment. The infrastructure investment policy likely meets this test but the regressive tax code likely does not.

US growth is therefore likely to be front loaded while the costs are back loaded. Companies’ earnings guidance and analysts’ estimates have tracked the exuberant sentiment and been upgraded this year for 2017 and 2018, and perhaps rightly so. In the meantime, current period corporate performance has slowed with fewer beats and more misses. *Much hope and expectation is built into the US equity and credit markets.*