

# Thurow presentation notes

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### **GDP: Dollar value or PPP?**

To look at the world economy, you have to look through two lenses. Through one of those lenses, we look at the GDP of each country in the world. The GDP of the world is approximately US\$31 trillion. The United States accounts for 32% of the world total, the EU is 25% and Japan is 16%. So together, the three big boys on the block account for essentially 75% of world GDP. And then if you add in the pool of wealthy countries – the Canadas, Norways, Switzerlands, Australias, New Zealands and a few Asian countries like Taiwan and Singapore – that's another 6% of world GDP. The 1 billion people in the wealthy industrial world – out of the 6 billion people in the world – produce 80% of the output. 20% of the people drink 80% of the beer.

Through the other lens, you look at what the economists call purchasing power parity (PPP). We take a basket of goods and services in say India, and compare it to what the same basket would cost in the United States, and assign that as income to India. And since purchasing cost, price levels, are lower in developing countries than the developed countries, the developing countries' share gets bigger. In fact, the developed world would now have about 55% of the total – as opposed to 80% – and the developing world has about 45% of the total. And splitting the world using this lens, the United State has 23% of the world economy, the EU is 20%, Japan is 8%, while the other wealthy countries having another 5%.

It is not that one lens is right and one is wrong. They are both right, depending on what you want to do. If you calculating world economic growth, it is the dollar number that counts. If we are looking at welfare issues – such as what the real standard of living of a Chinese is versus an Indian – then the purchasing power lens is relevant.

And the thing with Asia is you have the two countries, for which if you look through the different lenses, would change the most. This is because Japan has the world's highest cost level and China has the lowest. If you look at it through dollars, Japan is 16% of the world's GDP and China is only 4%. Japan's 4 times as big as China, economically speaking. If you look at it through PPP, China has 12% of the world's GDP while Japan has only 8%. China is now 50% bigger than Japan.

Since we are looking at economic forecasts, the only thing that counts here are the dollar numbers because that's what drives the economy. In which case what happens in developing countries doesn't make any difference to the total numbers, since 80% of the action is in the wealthy developed world, and it is actually the developed world that drives the growth rate in the developing world. Of course, this is one of those things that are a little wrong. We cannot forecast the growth rate in developing countries unless we first really know where the developed countries are going to be because that's where the markets are. It is especially true if you think about the United States.

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### Is the US Economy recovering?

Now if you look at the American economy in 2003-2004, you will see something different depending on what your background is. From an economist's point of view, we are having a quite nice recovery since we have positive growth.

The recession in 2001 has now been officially dated as lasting from March to November 2001. Since World War II, we have had 10 recessions in the United States, that ranged from the mildest (at 0.5% decline in GDP) to the most severe (which saw GDP decline by 3.6%). The shortest recession lasted 6 months and the longest was 16 months. The 2001 recession was one of the mildest – GDP went down 0.6% and the recession lasted approximately nine months. In 2002, the growth rate was 2.4%, and 2003 should be quite similar. The American government just revised the rate for growth up from 2.4 % to 3.1%. Compared to the growth rate in the 1980s, people would say it is a good recovery.

So why is everybody worried and talking about the US economy? Again, there is another lens. The reason many people don't see this as a recovery is that there's a big definition gap between what a business person calls a recovery and what an economist calls a recovery. To an economist, it will be a recovery as long as the growth rate is +0.1% for a time.

But business people do not care whether the economy is +0.1% or -0.1%. This is not an important distinction in the business world because what a recovery means is that the economy grows fast enough to start thinking about expansion and making profits, as opposed to downsizing and cost cutting. And looking through this lens, this is the worse recession in the United States since the Great Depression.

When President Bush runs for reelection in November 2004, he would have to say that there are fewer jobs than four years earlier when he first got elected. In fact, there are 2.4 million fewer jobs in America today than the day President Bush was elected and it is highly likely that the number will be even bigger by 2004. There's going to be a 2 to 3% growth rate in 2003 and 2004, but if you were a college graduate in America in May and June and trying to find a job, it was clearly the toughest job market since the Great Depression.

So there are two conflicting perspectives. It's the harshest recession since the Great Depression, yet it is also one of the mildest recessions we've had. The answer is found in the relationship between how fast the economy is growing and how fast productivity is growing. Back in the 1980s, productivity was growing 1% while the economy was growing at 2%. This created 1% in new jobs per year. On the other hand, in 2002, the economy grew 2.4% while productivity grew 4.8%. This is how the United States lost 2 million jobs.

The GDP growth rate has just been revised to 3%. In 2Q2003, productivity in the United States has grown 5.7%. Labor inputs are calculated by a different agency than GDP, but now that GDP growth has been revised, productivity growth must be up somewhere around 7%. To have a recovery from a businessperson's perspective, we need to have a growth rate of somewhere around 7%, depending on where productivity growth is. The problem is that nobody thinks that this kind of recovery is underway.

If you like to bet on political events, you can bet against the reelection of President Bush (Bush 43)<sup>1</sup>. It is said of former President Bush (Bush 41) that he lost the election because he had a lousy economy. But Bush 41 could claim at the end of 4 years to have added 2.6 million new jobs to the American economy. One other hand, Bush 43 will have to contend with being the 1st President since the Great Depression who lost jobs in his 4 years as the President of the United States. It is highly likely almost certain that every measure of the economy in November 2004 will be worse for Bush 43 than it was with Bush 41.

It is important, if you are trying to understand the forecasts, to understand the big difference between these two perspectives. We have to think about the characteristics of the different types of recessions: the "quick-up quick-down" recession; and those that go down and stay down or 'U'-pattern recessions. These would have a very slow recovery and maybe some double dips on the way back up.

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<sup>1</sup> President Bush Senior was the 41st President of the United States while Bush Junior is the 43rd President.

Out of the 10 recessions since World War II, seven were these quick-up quick-down recessions. What happened was that the central bank started to see inflation, and raised interest rates to curb inflation. And when interest rates are raised substantially, two industries – housing and normal bills – are killed. Housing and normal bills sales go down, and push the economy down very quickly. However, if the reserve board offered low interest rates, housing and normal bills would recover, and they would pull the economy back up.

The U-recessions – including the current one – were very different. The first was caused by the Korean War, because after the Korean War, we had large cut backs in defense spending. In the 1950s, you'll see repeated growth, slow growth, and a series of recessions in 1958, 1960 and 1961. The economy finally took off only five or six years later.

The second U-recession was after the first oil shock – a huge increase in the price of oil – in 1973. What policy makers didn't understand was that the big increase in the price of oil was equivalent to a big tax increase. The only difference was that it was paid to Saudi Arabia as opposed to the President of the United States. To avoid an economic slowdown, there had to be tax cuts or expenditure increases inside the United States. They didn't do it, and we saw repeated recessions in 1976, 1979 and 1981, and slow growth in between. It was only in the 1980s that the economy started growing again.

### **The root of the 2001 recession**

We are now recovering from our 3rd U-recession. This recession came out of two events. One was the dot com stock market crash. But that had a rather minor impact compared to the crash of telecommunications investments. And this came about for a very simple reason. If you going to make a society work, you have got to have a certain number of key characteristics and one of them is optimism. Everybody in this room has got to believe, "my firm is going to win". If you don't believe that, you are going to work for a different firm. Or else you'll be run out of business and lose your job anyway. So take any industry, send a survey to every firm in the industry, and ask "What is your market share going to be next year?" Add up the numbers, and they will be greater than 100%.

In an industry like telecommunications where you have to build an infrastructure ahead of sales, this means that there will be cycles of over-investment and recessions to work off those investments.

Now in the telecommunication industry, there were actually two sets of optimisms – one was that "My firm going to get a bigger market share" and the second is "The market's going to grow like crazy." Now when you do that, you set yourself up. The second set "The market going to grow like crazy" just isn't quite right. And if you look at the 2001 recession in the aftermath, it is almost entirely a recession in telecommunications.

In 2000 and 2001, we invested about US\$31 billion a quarter in telecommunications, or about US\$120 billion per year in fiber optics, service routers, Internet and all that. Then in 4Q2001, we had a 9 billion dollar cut in telecommunication investment and telecommunication investment went downhill from there. And the reason it went downhill was not a surprise.

One of the two companies that keep track of fiber optics reported that 96% of all the fiber optics buried in America in the last five years has never been used. The other company says 98%. That's a lot of optimism. There are also stretches of cable across the Atlantic and the Pacific that have never been hooked up to the network because there is no demand for them. Another problem is that technology is also advancing so we can now send more information down any fiber optic cable without investing in more cables. It will take a long time to absorb all that telecommunication investment. This will put us in a U-recession where we will likely see feeble growth rates instead of double dip recessions we are already seeing in Europe.

Now to create a businessman's recovery, we will need to bring the growth rate up from 2 to 3% to something like 5% or 6%. The question is, what is out there that would boost our growth rate by more than a factor of 2. Looking through the elements of GDP i.e. consumption, business investments, residential investment, exports minus imports, state government spending, overall spending, we can find elements to sustain the 2% growth rate, but not where the additional 2 to 3% going to come from.

Look at consumption for example. The American consumer has lost US\$7 trillion in stock market wealth, but is still spending like crazy because of the low interest rates. Why lower interest rates? Alan Greenspan knew he couldn't turn business investments round and he hasn't done that. The answer of course, is that he was worried about the double recession. A double recession would happen because with telecommunication investments going down and the stock market crash, the American consumer would cut his consumption, causing a 2nd dip in the economy.

But Greenspan had a way to prevent that. 90% of the American population has more equity in their home than they do in the stock market. So, driving home values up would offset the effect of the stock market falling, and prevent most families in the United States from having any net negative effects. By driving interest rates down, the monthly installment of a house is reduced, allowing people to buy more house with a given down payment. This pushes house prices up, and it has been a great success.

To 90% of the population, the fall in the stock market is irrelevant in the sense that they have gained more in the appreciation of their homes than in the falling value of their stocks. Now this isn't true for the top 10% of the population, but it works for 90% of the population. So Greenspan was very successful in preventing the 2nd dip in the American economy.

### **Outlook for the US Economy**

However, consumption alone doesn't give the increase needed for a real business recovery. There is just no way that the American consumer could increase spending to a rate high enough to drive the economy. Residential investments are already booming, and you can't add up boom to a boom. So it's not something to get us far.

Business investments, for the reasons we have discussed, are not going to go up. It is going to take time for telecommunication investments to take off, as well as business investments in the rest of the economy. But after what happened in the telecommunications industry, there is no reason for other industries to make major investments of about US\$120 or 130 billion a year. Inventory investments can't do it either, because they reflect the state of the economy.

A boom from Exports minus-imports – driving the American economy by demand in the rest of the world – would also not happen because the growth rate in Japan is essentially zero.

That leaves us with the US government – the federal government and the state governments. Now, the federal government has organized some big tax cuts and they have increased spending. By itself, the federal government's policies can help push the economy up. State governments in the United States are very different from elsewhere in the world, where state governments are heavily financed by the central government. In the United States, state governments are self-financing. They collect taxes and raise their own money, but they can't print money.

Together, the US state governments employ three times as many people as the federal government. And how they work is that they look at their revenue in 2000 and decide how much money they can spend in a year later in 2001. So in the recession year 2001, state government spending was still going up because of the increase in tax revenue in 2000. In 2001, however, tax revenue goes down, and that leads to a deficit in 2001. The state governments can maintain spending levels for one year because they all have rainy day funds. By 2002, however, the rainy day funds are exhausted, and state governments either have to cut spending or raise taxes. So there is a US\$50 billion tax increase and US\$30 billion cut in expenditure. And this 'negative' policy offsets the federal government's efforts to result in a net effect of 2% growth.

And so the US growth rate forecast in next year or two will be more or less the same – about 2 or 3%. It is very hard to see how we will get to 5%. This kind of a growth rate means that the number of jobs in the American economy will fall because of the rise in productivity growth, which has increased from 1% a year in the 1980s to 6 to 7% currently. Part of it has to do with technology – computers, microelectronics, biotechnology and new materials – which adds something like 3% a year to productivity. The other 2% point of gain in productivity comes from a very simple fact – we have taken the most inefficient things we do and moved them to China. Our productivity increases – but this is the type of productivity where we do nothing but lose jobs.

We started to get worried when in the 1990s, 60% of the all the GDP added to the world economy was added inside the United States. In the 2nd half of the 1990s, Japan was not growing and Europe grew very slowly. And that's not a good balance. Because, what it basically means is that the world would depend on the American economy for their growth. And that's what has happened. In 2003, the United States runs a US\$500 billion deficit. It's remarkable how evenly spread it is. Japan has about US\$100 billion; China has about US\$100 billion; South East Asia has about US\$100 billion; Europe has about US\$100 billion; and the American continent plus Canada has about US\$100 billion.

### **What happens if the US Trade Deficit is reduced?**

What happens if the US trade deficit goes away? In 1999, the US government appointed a Trade Deficit Commission, which published its mission report one week after the Presidential elections in November 2000. The Commission agreed on several points:

One, the trade deficit cannot last forever. It was simple mathematics – if you had a US\$500 billion trade deficit one year, and you had to borrow money and pay compound interest. Eventually, this amount of money would have to be returned or passed on. It won't last forever.

Two, if the US trade deficit ends, it will be like an earthquake where the epicenter is in the US, almost all the buildings that will be knocked down are in the rest of the world. America would gain some 10 million jobs, but because of different levels of productivity, this translates into 20-25 million jobs that are lost in the rest of the world where we buy things from. Take the automobile industry for example. We make about 16 million cars a year in the United States and we imported an additional 3 million. Now if the dollar went down and Americans couldn't afford to buy those 3 million cars, it would take two months at the most for Americans to make those additional 3 million cars. They do two shifts and can ramp up to three shifts. But how long would it take the automobile factories in the rest of the world to find another place to sell those 3 million cars? The answer is that that can't be done and they would have to shut down.

The Commission also agreed that to cure the US trade deficit, we would need something like a 40% decline in the value of the dollar. And the financial markets always overshoot, so you can expect something like 60% decline that would eventually come back to 40%. If that happens, every supply chain in the world has to be ripped up and laid down in a different place. Because places that were cheap become expensive, and places that were expensive become cheap. And lots of people would have factories and logistic chains in the wrong place.

Nobody can determine the timing. In that sense, economics is just like geology. We know in California exactly where the San Andrea's fault is, and we know with 100% certainty that there will be an earthquake on the fault line. But we don't know if it will happen one second or a thousand years from now. And when the change came, would it be a soft (gradual) or hard landing (quick)? The Republicans in the commission want to believe in a soft landing. The Democrats don't agree for very simple reasons – the world has never seen a soft landing – it doesn't exist.

Think about the dollar going down 40%. It would have to decline 8% for 5 straight years. Is that credible? Everybody would sit and watch their dollar holdings lose 8% of their value every year for five continuous years. Financial markets don't do that. The 1st guy to leave the door wins and the last guy to leave the door loses. It's the herd mentality – everybody rushes to the exit.

Knowing the timing is difficult because in one sense America is unique when it comes to a trade deficit. If Mexico or Thailand had a trade deficit, in principle, it's possible to figure out the timing because you could go to any lending officer in Citibank, and you say "How much more money would you be willing to lend Mexico before you think it's too risky and quit lending?" And they can give you an answer. But the United States does not borrow money to pay for the trade deficit. The United States sell assets. When we sold Chrysler to Mercedes, Rockefeller to the Japanese, and dot coms to the Saudis, we pay for the trade deficit. The problem is that, if we take the last 20 years, we've run up an accumulated trade deficit of US\$3 trillion. And we've sold US\$3 trillion worth of American assets.

As of the moment, we still have US\$31 trillion worth of assets left. The issue is not whether the world wants to stop lending to America, but when the rest of the world will quit buying American assets. And that's very different from the question of when to quit lending to Mexico. The only honest thing the economists say is "I don't know".

This would be an economic nightmare. And the problem is, the faster the American economy grows; the more likely is that the nightmare going to be true. If the US economy did accelerate to a 5% or 6% rate, that means that the United States is going to have a really big trade deficit – say US\$800 to 900 billion instead of US\$500 billion. There is no neat answer.

#### **New model of economic growth required for developing economies**

And this will have an enormous impact in every developing country aside from the fact that they going to move supply chains. Because the standard model of economic growth in Asia is export-led growth, set up by the Japanese. In export-led growth, you have exports that grow about twice as fast as GDP. That's what happened in Japan in 1960s and early 70s. You build up export surpluses – like we've seen in this part of the world – and the export industries drive the economy forward.

Now there's a problem here. Suppose the whole world want to do export-led growth. That's mathematically impossible because in the aggregate, the surpluses have to be equal to the sales. Therefore, export-led growth is possible only as long as somebody is willing to have trade deficits. And at the moment, the only somebody is the United States. If you go to the developed world – say Japan and Germany – and you say "How are you going to get over your slow growth?" they will say, "Export more to America". Now, export-led growth is dying or going to be killed for two reasons. One is that the market will disappear in the United States at some point. The other reason is China, which is taking export market share away from everybody else.

The countries that are going to be successful are the ones who first figure out a substitute for export-led growth.

The strategy will probably look a little bit like the strategy in the United States in the late 19th century – where you basically pull the economy forward with massive investments in infrastructure. And to finance those investments in infrastructure, you make it profitable for foreigners to invest in your infrastructure. And that's one of things where governments will have to change their view of the world. Because the problem with capitalistic investments, is that many of them lose money, and most don't make very much money. But occasionally, you can a blockbuster investment that covers your losses in all your other investments. It is like the drug business. Most drugs don't work, never hit the market and cost you a lot of money. Other drugs hit the market, but don't pay their cost. The industry is only profitable because it has blockbuster drugs. But if the government says you can't have blockbuster drugs, then you can't run a successful pharmaceutical company.

The same thing is true in infrastructure. When outsiders invest in infrastructure, most investments are going to fail. And when there's a big success, the government has to let them reap the profits. In the US in the late 19th century, the British paid for our railways, which was then the key infrastructure. And they make enormously good rates of returns on those American investments. Since it was a different era, there was no thought of government stopping them from making those rates of return. But the thing you have to think about is that the model for economic development in this part of the world cannot possibly last. The question is who is going to come up with a new model first and who will implement it first.

The export-led growth model worked in Asia because the countries that used it then had small populations and low GDP relative to the rest of the world. When Japan used the model in the 60s and 70s, it had 110 million people. When Korea, Taiwan, Hong Kong and Singapore adopted the model, they were 65 million people vis-à-vis the world. But when China and India start doing it, the model collapses because we are now talking about one billion people. The export-led growth model cannot handle these kinds of numbers.

### **What is the economic significance of Iraq?**

Iraq is very important politically and in military terms, but in economic terms, it is irrelevant. Iraq has 22 million people with a per capita GDP of US\$1,000 – a GDP of US\$22 billion. US\$22 billion compared with US\$31 trillion is trivial. The war in Iraq cost America US\$78 billion. America's GDP is US\$11,000 billion dollars. Even if it cost US\$100 billion a year to stay in Iraq, it is not an important number. So relative to the world economy, or to the American economy, Iraq does not have much economic significance.

### **The Disease of Deflation**

Japan caught the disease of deflation first. It has spread in East Asia, and it looks like it may be spreading to Germany and the United States as well as South East Asia. If the falling dollar is the equivalent of a great earthquake, then deflation is the economic equivalent of SARS – it kills you slowly. No capitalist economy has ever generated economic growth in the presence of deflation for some very good reasons.

Think of the United States at the beginning of the Great Depression. The rate of inflation was minus 15%. If the rate of inflation is minus 15%, the number one thing you have to do is pay off debt – because a \$100 debt today, in real terms, will be a \$115 at the end of the year. Everything else has to be cut back to make room to pay off debts. What's the real rate of interest if the inflation rate is minus 15%? Since the money rate can never be lower than zero, the real rate of interest is 15%. So we have an absolutely 'risk-less' and effortless investment that yields a 15% rate of return. How many investments in capitalism can yield 15% with no effort and no risk? The answer is precisely zero. Therefore, if prices are falling 15%, the smart consumer waits until the next year because it's going to be 15% cheaper.

And what happens to real wages? The only way real wages do not go up is if you cut money wages 15% every year. For a whole variety of sociological reasons, that's almost impossible. Prices in Hong Kong have fallen 13% recently. And the Hong Kong government tried to cut its civil servants' wages by 6%, which would have left them with a 7% real wage increase, but they were unhappy and went on strike.

During the Great Depression, there was no welfare or unemployment insurance. Unemployment went up to 30% and real wages still rose. Money wages fell, but prices fell faster so real wages were, in effect, rising. If selling prices are going down and real wages are going up, you go broke. Everybody does.

Deflation may have started first in Japan because of its financial crisis. But the reason it is spreading to the rest of the world does not have anything to do with the Japanese crisis. It has to do with an iron law in economics – prices follow costs. Not immediately, not one-to-one, but if costs go down, prices will go down. The first guy to lower costs makes more profit, but then everybody figures how to do it, and prices go down.

One way is by offshore production. If I move production to China, and cut costs by 30%, my selling price will also go down – maybe not by 30% but by some amount.

Two: Technology – new technology is reducing prices of computers and microelectronics, and they are part of the economy. When their cost goes down, they get used more in other industries, and it raises productivity and lower prices in those industries.

Three: Outsourcing – Ford and General Motors split off their supplying divisions, and require them to lower prices 3% a year. If they don't make any money, that's their problem. When the suppliers are part of the parent company, beating up on them doesn't do anything since there's no net gain. But if automobile parts costs go down 3% a year, sooner or later car prices will start to go down. And in the last two years, for the first time since World War II, new car prices in the American CPI have gone down.

Four: Financial crisis – If the Koreans have a financial crisis and the value of the Won goes down 50%, anybody competing with the Koreans have got to lower their prices by 50%. Because the Koreans can do it and still make money.

Five: Deregulation and privatization – Take any industry that has been deregulated in the United States, and the prices in that industry are down.

Finally, there's expanding capacity. Take almost any product that you think of, add up the production of all the factories in the world, and then estimate how much the world is going to buy. You will find better than a third in excess capacity. The world's automobile companies can make 88 million cars. They will probably sell 65 million cars. This means there is capacity to produce 23 million cars that won't be bought. And this creates tremendous downward price pressure.

And of course, what we see is deflation spreading. In Germany, the measured inflation rate is zero. But about a third of the German prices are controlled by the government. If you look at the prices that are not controlled by the government, it is clearly negative. In America in 2002, the measured inflation rate was 1.2%, but 0.9% of that was healthcare – which isn't related to the rest of the economy at all. If you look at the non-healthcare economy, the inflation rate was 0.3%. And that was in a year when oil prices went up to 26%. So outside of the energy sector, everybody in America was in a world of falling prices. And what we saw in 2002 is that for the 10th, 50th, and 90th percentile of the workforce, wages fell in real terms.

### **Strategic Direction of the European Economy**

Normally, central banks can't stop recessions because they can't predict when they are coming with enough certainty. But in this case, the European Central Bank could see the American recession coming six to nine months before it came to Europe. They could have – at least in principle – done something to prevent it. But their view was that "We don't export very much to America, and the fact that America has a recession will not make very much difference." In 2000, before they saw the American recession, they thought that Europe would grow 3.6% in 2001. In December 2000, when the American recession was obvious, the Central Bank made the same comments, and lowered their forecast. In June 2001, they lowered their forecast to 2%. In November 2001, when the year was nearly over, they lowered their forecast to 1.8%. The actual number was 1.0%.

What they forgot was that the thing that caused the recession in the United States – telecommunications investment – was worse in Europe. In America, we bought fiber optics and routers. In Europe, they bought pieces of paper – spent US\$150 billion across Europe on 3rd generation telephone licenses. What are those licenses worth today? Technically, they have a negative value because it's an obligation to build a network that nobody wants to build. Assuming the obligation wasn't there, they would have zero value. And we have a group of firms that have wasted US\$150 billion. So the decline in the stock market was bigger in Europe than it was in America. Their 1st recession was bigger and longer than it was in America. They are now a double dip recession, which the US has not had.

During the period Alan Greenspan reduced interest rates about 12 times, the European banks lowered interest rates twice. They have just done it once more for a total of three times. There are only two possibilities – either Greenspan was wrong and lowered his rates too many times, or the European Central Bank was wrong and didn't lower rates enough.

The Europeans also have this stability pact that basically says that they can't use fiscal policies but technically, they are all supposed to move to a balanced budget by 2005. So they are going to raise taxes and cut spending in the middle of a recession. There's no sense that anybody is driving the system.

There are five European think tanks – institutes called the wise men – they write a report twice a year to the European Central Bank. The title of the last report they wrote was "Against Action". The question was "What should we do to restore economic growth in Europe?" and the answer was: "Wait for the American recovery". If the Americans don't have a recovery, wait a little longer.

There is this feeling that nothing could be done in Europe to manage the European economy. And so there it sits with its zero growth rate and no plans to do anything about it except to wait for the American economy.



### **What is China's actual growth rate?**

The one thing you learn about a developing country is to never believe any of the numbers. If you start investigating the system as to how the numbers are arrived at, you'll find out very quickly that there's almost no relationship to what the real number ought to be.

In the 1980s, you could believe that China had a 10% growth rate. This was because the real miracle in China was not in Shanghai or in Beijing or Guangzhou, but in the countryside where 70 or 80% of the people lived. In 1978, Deng Xiaoping got rid of the communes, installed the family responsibility system and every hectare of land was handed out to some peasant.

In six years, agriculture production doubled. And in the next seven years, it doubled again. If agriculture production doubled every six or seven years, and 80% of the population is in farming, it is easy to believe the 10% growth rate because good things were happening.

But in the 1990s, the announced growth rate was 9.7% per year, and that's unbelievable for many reasons. First, the Chinese announce that there is no growth in the countryside. So 80% of the people are living in the countryside with a zero growth rate. So, for the national growth rate to be 10%, the growth rate of the people living in the city has to be 50% a year. Now Shanghai is growing, but not at 50% a year.

Second, if you look at published Chinese statistics, you will find that the provincial GDP figures do not add up to be the national GDP. In 2001, the head of statistics in Beijing admitted that every province in China reported a growth rate of more than 8%, and he adjusted them down all down to 7.3% but did not say why. And 60,000 people who were prosecuted for over-reporting.

Third, from 1997 to 2000, the Chinese GDP supposedly went up 36%, but its consumption of energy (in BTUs) went down 18%. I think that violates some rule of thermodynamics.

Fourth, in 1998, Hong Kong reported a fall in its GDP of 5% while the mainland reported an increase in its GDP of 8%. If the mainland is growing at 8%, the coastal cities have to be growing a little faster. So the city of Guangdong near Hong Kong – 250

million people – grows at 8-10%, while the city of Hong Kong – of 7 million people – shrinks 5%. No economic model makes this possible.

Fifth, from 1986 to 1996, the inflation rate in China is 9.4% per year. Suddenly, in 1997, it falls to -1.3% in 12 months. The only thing in the world that could bring inflation from 10% to minus 1% in 12 months is a recession. Yet in the statistics, China did not have a recession in 1997.

Sixth, the export growth rates in China from 1997 to 2001 were as follows: +22%, 0%, +85%, +30% and +7%. This is an export-driven economy, and exports are bobbing up and down, but the growth rate remains absolutely flat. It made no difference to the growth rate whether exports were going up 85% or not going up at all. It simply doesn't work.

What we have to understand is the system of bottom-up reporting and top-down promotions. Mayors and governors in China mail their statistics in. It's like you work for a big company – called the Communist Party. If I'm a good major in a little town, they may make me a mayor in a big town. If I'm a good mayor in a big town, I get to be mayor of Shanghai, and the next job I get is in the Central Committee. Zhu Rongji used to be the mayor of Shanghai.

Would you want to be the 1st mayor in China to write a report to Beijing that says "My economy is shrinking"? That would be the end of your career. So what you get is consistent exaggeration up the ladder.

The standard thing then is to look at the consumption of electricity. For most countries in the world, there is essentially a two-to-one relationship – that is, to get a 1% increase in GDP, you need a 2% increase in electricity usage.

From 1972 to 1989, China managed to get 1% increase in GDP with a 1.4% increase in electricity. That makes it about equal to Japan – which is the most efficient country at using electricity. We can believe it because we know that communism was very inefficient with electricity, so when you redirect some of it, China could then have had the same relative growth as Japan.

But in the 1980s and 1990s, China claimed to increase GDP by 1% with only a 0.8% increase in electricity consumption. In the 12 most rapidly-growing countries in the world, the relationship is that there is a 1.9% increase in electricity for each 1% increase in GDP. The best performance of any big country in history has been 1.1%. And that was in the year that Japan was closing down its aluminum industry in the mid-1970s, and redirecting the electricity into other industries. So to believe China's reported growth rate in the 1990s, we have to believe that they were 30% more efficient than the Japanese when they were at their very best at using electricity. Assuming that China cannot be better at using electricity than Japan, we would come to the conclusion that China's growth rate is somewhere 4% and 6%.

I don't believe the numbers in India either. In India, you are growing at 3.5 or 4% a year, your benchmark competitor China claims to be growing at 10%, and you're worried about getting smaller relative to them. Right up from the bottom, people start reporting better numbers, and the growth rate suddenly goes up from 3.5% to over 6%. But what caused it? I asked people in India what made the growth rate go from 3.5% to over 6% -- did they invest twice as much, did they educate people, did they get new technology, are there good things happening on the farm? -- but nobody could tell me the story; the growth rate just went up. The answer is that the growth rate didn't go up. I don't know what the real growth rate is, but I don't believe the 6+% growth rate in India anymore than I believe the 9.7% growth rate in China.

### **Conclusion**

Where does this leave us? It is like in the play, *Waiting for Godot*, where everyone is waiting for Godot, and that when he arrives, things will get better. Nobody really knows why. And when the play ends, Godot never shows up. In our play, the equivalent of Godot is a higher worldwide rate of growth. Capitalism being what capitalism is, Godot will show up. But I don't know when.