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CLIENT MEMO

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Good Summer Reading — A Brief Discussion of Five Topics

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Good Summer Reading — A Brief Discussion of Five Topics

1. Resolving the State and Municipal Pension Crisis Fairly
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1. The State and Municipal Pension Crisis

Meredith Whitney is proving to be correct in her forecasts one more time. She warned us over a year ago that dozens of municipalities and certain state governments could go broke due to the burden of excessive and unfunded pension (and medical care) liabilities. There are four aspects of this emerging crisis that must be disentangled. *First*, most such pensions have been underfunded because local governments were either unable or unwilling to spend the money required to fund the liabilities they incurred via their bargaining agreements with various unions. *Second*, funded or not, the retirement packages were excessively generous — especially at a time when the retirement prospects for non-governmental workers were looking more and more bleak. The result is an embarrassing disparity between what public and private sector workers can look forward to upon retirement.

Third, there is the question of whether filing for bankruptcy *can* in fact relieve local governments of some of their pension burdens. This is a pivotal question because a good number of states rendered such pension payouts "constitutionally protected" under state law. The jury is still out as to how much a city or state can renegotiate previous pension promises and the outcome hinges upon court rulings. *Fourth*, there is the murky issue as to whether and to what extent promises to cover medical costs are binding. The reason there is so little discussion of this additional (huge) liability is that unlike pension liabilities, the terms of the agreements to cover pensioner health care vary greatly between municipalities, and few such liabilities are constitutionally protected.

We separate these different dimensions of the pension liability problem because they are usually conflated, making it unnecessarily difficult to analyze and solve the problem. In what follows, we try to offer two new perspectives on the problem — both of which suggest that today's promises to workers should *not* be binding, and must be renegotiated. The first perspective is based upon the moral principle of intergenerational equity. The second is based upon an advanced concept of economic efficiency.

Intergenerational Equity and Fairness: Should local governments prove *unable* to reduce their payouts, say because of constitutional protection, the fate of local governments has now become clear: inadequate and diminishing public services (police, fire, and education) amid ever-rising local taxes. Given the increasing resistance to higher taxes because of stagnant (if not declining) living standards, the axe will fall the most on the budget for public services. We are already seeing this in the form of:

- Two-hour waits for a response to 911 calls
- Philadelphia schools facing difficulty opening on time
- Detroit mulling the sale of the contents of the celebrated Detroit Institute of Fine Arts
- The near suspension of services in a host of cities

The author was invited by the London Society of Actuaries to address this matter back in 2004. The solution he came up with then would seem to apply today. The driving concept is that of "an incomplete agent game" which draws from game theory. A bargaining game of *complete* agency is one where a bargain is struck by **N** agents (representatives of labor and management) where these agents represent the differing interests of *all* parties impacted by the negotiations.

By extension, an incomplete agency game is one where a number **S** of agents, whose interests are impacted, are *not* included in the set of the **N** agents at the bargaining table. Thus, what should have been an **N + S** person game ends up a "truncated" **N**-person game. In the context of today's public employee pension crisis, the parties not represented at the table have included **(i)** the taxpayers who will foot the bill for gigantic shortfalls and will suffer from deteriorating public services, and **(ii)** the members of future generations of public employees who — because of the blatant bias of previous negotiations — will face vastly reduced pension and related benefits compared to what current retirees enjoy.

> *Our fundamental point here is that any agreements reached in incomplete agency games are illegitimate, are not legally binding, and should be exempt from constitutional protection. Another way of saying this is that, to be legitimate, a bargaining game outcome must treat symmetrically the interests of all those impacted by the outcome of negotiations.*

An important jurisprudential issue arises here: Are laws "legal and binding" if they are as blatantly unfair to those impacted but not represented as has been the case in pension negotiations? Serious legal scholars such as Chief Justice Oliver Wendell Holmes (not to mention nearly all moral philosophers) have answered "No" to this question. After all, morality is the basis of legitimate law. So, morally illegitimate laws (including those governing some pension contracts) should not be viewed as binding.

Conversely, legal positivists maintain that laws are laws regardless of their degree of fairness. The problem with the positivist position is that, if public political opposition is strong enough, the public will elect governments that legislate new laws redressing the underlying problem; state constitutions can be rewritten if public outrage is great enough! In other words, fairness will *ultimately* prevail. This being true, it seems prudent to take action sooner rather than later. Along these lines, state supreme courts could decide that existing pension contracts are too burdensome, do not serve the public interest, and are thus invalid even if they were protected by state constitutional law back in better times. This observation leads directly to our second justification for invalidating many existing contracts.

Economic Efficiency and Contractual Contingencies: Most readers probably know that virtually all contracts contain *force majeure* provisions that invalidate the terms of the contract in the event that "extreme, unforeseeable circumstances occur." In short, if you cannot get blood out of a stone, stop trying to do so. It might seem strange that this *force majeure* concept is linked to the all-important economic concept of societal efficiency (no waste), but it is — and the two are linked at the deepest possible level. For in his epic 1953 paper which introduced the "economics of uncertainty," Stanford economist Kenneth Arrow proved the following result: In a world with uncertainty about the future, economic behavior will lead to efficiency if and only if all agreements are *contingent* upon future (currently unknown) "states of nature."

In the present context, this translates into: We cannot promise retirees a guaranteed level of benefits, for we do not know what the future holds and whether these will be affordable. Instead, benefits will be a function of the future states of the world. If the economy is good, the markets do well, and pensions are overfunded, payouts will be larger — and vice versa. A beneficiary seeking "guaranteed income" could surrender his/her *contingent* payout contract for some lower, risk-adjusted *guaranteed* annuity. This would pay *less* than the *ex ante* mean of his original unguaranteed annuity payout.

To conclude, we have reviewed two very deep justifications — one moral, one economic — for the view that overly generous and non-contingent pension promises to public employees are illegitimate.

2. Interest Rates and the Longer-Run Performance of US Equities

In two months, we shall publish a research ***PROFILE*** entitled "The Long-Run Consequences of Ultra-Easy Monetary Policy," a topic as difficult as it is important. The Fed's exit not only from QE, but more importantly from its ultra-low Fed funds rate will be *the* big story for markets over the next five years. Because of this summer's jitters in the global stock markets over fears of Fed tightening, we now borrow some of the logic from our forthcoming October ***PROFILE*** and apply it to prospects for the US stock market.

The longer-run performance of the stock market largely depends upon **(i)** the level and expected trajectory of interest rates, on **(ii)** the growth rate of earnings, and on **(iii)** the multiple paid on earnings, i.e., the P/E ratio. In past research we have focused on the reasons *why* the P/E ratio tends to and indeed should mean revert to an average valuation of about 15. Today's S&P-500 ratio is just over 15 assuming a current market index of 1650 and estimated earnings of $108.[1] A ratio of 15 is of course the long run empirical and theoretical average of the P/E ratio for the equity indices of many nations.

The question we now address is whether the US stock market will do well during the next two decades — or not. We are somewhat bearish for the following reasons: *First*, interest rates (the entire yield curve) are much more likely to rise than to fall, which is most likely bearish for the level of the market. *Second*, the remarkable growth of earnings during the past 15 years will almost certainly slow, which is also bearish (Indeed, this is beginning to happen). *Third*, the multiple paid on earnings (the P/E ratio) will probably fall, not rise, which is also bearish for the level of the market.

Let us discuss *why* the second and third of these developments are likely to occur. The first (rising interest rates) need not be discussed, given that interest rates have been and remain exceptionally low and will certainly rise — unless a long-term recession/depression occurs.

Earnings Growth: Three observations jump out from the earnings data upon analysis. *First,* the growth of US real earnings during the past few years has indeed been remarkable, and few expect it to continue. *Second,* and what is much less known, real earnings growth has become extremely volatile since about 1980.[2] *Third,* the long-run growth rate of real earnings mean-reverts to a rate of about 1.5% over the long run, much lower than its average growth rate during recent years. Deep economic theory suggests why real growth *should* be around 1.5%: it is approximately the level of mean productivity growth and real GDP growth. No one has convincingly argued that this relationship should change.

[1] On a trailing P/E basis, today's ratio is approximately 19.

[2] Part of the increase in volatility is due to the increase in endogenous risk within the market — a phenomenon largely driven by the rise in leverage made possible by the utilization of derivatives, as well as by the related introduction of private equity leverage.

As for why earnings growth has been as robust as it has been, there are four principal explanations.

First, there is the "gift" of monetary policy: both extremely low short-term interest rates and sustained QE. This has been a boon to corporations seeking profitably to refinance balance sheets, and seeking for a low "rental fee" for their previous and new capital investments. Just as with the previous housing boom/bust and the tech boom/bust (both of which temporarily boosted current earnings far above the long-term growth trend), the Fed's current ongoing monetary expansion is enabling another boost in earnings growth well above its long-term trend.

Second, the US government's abject failure to enforce free and fair trade with emerging market nations has also helped boost profits on the part of those who wish to and can outsource, as argued above [We once saw an analysis of what Wal-Mart's earnings growth would have been since 1990 *without* the ability to outsource jobs at the high rate they did, and to purchase imports from China at values of the yuan that even today are about a third what they ought to be according to established fair trade theory.[3] The earnings growth projected by this "shadow analysis" was about *half* of what Wal-Mart actually achieved].

Third, the high earnings levels of recent years reflected the explosion of earnings in the financial sector of the economy. Because of the myriad (and confusing) ways in which the "financial sector" is defined in the literature, it is difficult to get a handle on how big a role the financial boom played in driving-up earnings. In any event, it is generally agreed that earnings growth in the financial sector will henceforth be significantly slower than in the past, in part due to financial sector reregulation.

Fourth, at a more abstract level, and for many reasons that will be reviewed in our September ***PROFILE***, the share of national income going to labor has declined by over 5% since 1980. Since the share of national income (and equivalently GDP) going to labor plus the share going to capital (more specifically, the rent accruing to the owners of capital) must add up to one via national income accounting logic, the share going to capital must *necessarily* have risen by 5%. There is a deep story here to be investigated in our forthcoming September report.

The boost to earnings implied by all four of these developments will abate as the first three of the above stories cease to hold true. The verdict is out as to whether labor's share of national income will rise back to 65% from today's depressed 60% of income — a development that would significantly depress earnings growth if it occurs.

[3] Chapter 5 of the author's 2012 book *American Gridlock* explains these points in detail, and is highly critical of the US government's failure to protect its own workers and stand up for free and fair trade when it had the power to do so.

The P/E Ratio: What disturbs us about the behavior of the P/E ratio is its failure to have mean reverted to its historical long-term value ever since the boom of the US stock market beginning in the early 1980s. This point might seem to make no sense since today's valuation of 15 times current earnings corresponds exactly with the long-run mean valuation of the S&P. Here is the source of confusion on this point: In order for *true* mean reversion to occur, the market's valuation must fall well *below* its long-term mean in order for the mean to become the mean — assuming that its valuation has been *above* its mean for several decades as has been the case in the US.

Thus, we must ask whether our children in twenty-five years will find a multiple of 15 times earnings to have been the mean valuation of the market between 1980 and 2030. If they are to do so, the market will have had to experience a significant period when valuations were well *below* 15. What might cause this to happen? One explanation might lie in the impact of rising short and long term interest rates not only on earnings but on the valuations placed on earnings. But there is a second and more subtle explanation. Once both the rate of earnings growth *and* the valuation of earnings start to decline, the lackluster annual returns that this implies tend to create a pessimistic market Belief Structure about future of equity returns. Such Belief Structures tend to be "persistent" and thus become self-fulfilling. This is perhaps the best way to understand long bull- and bear-market trends where persistent optimism/pessimism plays a greater role in driving the market than news about fundamentals.

To conclude, should interest rates rise as they will (barring a recession/depression), should the growth of earnings mean-revert back down, and should the P/E ratio mean-revert as theory says it will, the performance of stocks as an asset class could be disappointing for quite a long time, even if fundamentals prove satisfactory.

Caveat: Our analysis here is somewhat one-sided because we have restricted our attention to certain aspects of market behavior that are rarely discussed. We have not discussed several reasons for equity market optimism — for example the prospect that companies will payout much larger dividends than they have during the past three decades. With retiring baby-boomers desperate for yield, this could render stocks quite attractive.

3. Two Fallacies Fallacy Behind the Importance of the "Big Data" Revolution

"I have seen the future, and it is here: Big Data." So proclaimed one computer pundit in a recent interview. In this spirit, article after article published during the past year supports the view that the advent of Big Data constitutes a transformative event.

To be sure, for people in certain kinds of businesses (e.g., e-marketing), the more information that is available about potential customers and their characteristics, the better. Additionally, the cheaper it is to obtain such useful information (e.g., online), the better still. The fly in the ointment of this logic is that *all* potential competitors of a firm that first utilizes Big Data can follow suit. As they do, “excess returns” from innovation ultimately get driven down to zero as we learn in Econ 101.

In the financial world, high-frequency trading was heralded as the Next Big Thing given its ability to exploit more and more data at ever higher frequencies. Today, as everyone and his brother goes into this business, and as the cost of the computers needed to excel rises inexorably, trading houses are finding such trading ever less profitable. Sound familiar? And what by analogy did the great American writer William Faulkner say? “Everywhere I look and see the same mad steeplechase to nowhere.”

What we wish to do in this essay is to advance two arguments *against* the importance of Big Data, both to the economy, and more broadly to the advancement of social welfare.

Value to the Economy: No one disputes the value to the economy (productivity growth in particular) of the Industrial Revolutions of the 19th and 20th centuries. Advances such as running water, the steam engine, the internal combustion engine, and electric power caused high productivity growth and increases in living standards of a speed and magnitude never before witnessed in thousands of years of human history.

But many eminent economists are openly questioning whether the impact of the internet and of Big Data in particular will make any such impact. These economists include Robert Gordon of Northwestern University, Joel Waldfogel of the University of Minnesota, Scott Walsten of Georgetown, and Nobel laureate Edmund Phelps of Columbia University. One argument they cite is that ever since the time of the introduction and utilization of the web (starting with email), the rate of productivity growth has been slowing — not increasing as many had expected.

A second argument has to do with a “cannibalization” hypothesis: Is the Big Data industry thriving because it is cannibalizing existing businesses in the quest for more customers? Or is it thriving because it is creating fundamentally new economic opportunities? Professor Waldfogel states: “One falls, one rises — it’s pretty clear that the digital is a substitute for the physical …So it would be crazy to count the whole rise in digital as a *net* addition to the economy.” Yet this is just what most analysts have been doing, and so Waldfogel’s point is valid.

In a different direction, Scott Wallsten at Georgetown has stated, “I think it’s conceivable that the data era will be a bust for the things we expect it to be useful for.” Of course, many optimists oppose these views and believe that it is far too early to attempt to fathom what the net impact of Big Data will be.[4]

[4] These quotes were taken from an overview of this matter published in the Business Section of the *New York Times*, Sunday, August 18, 2013.

Value to Social Welfare: Transcending mere economic concerns, will the advent of Big Data make possible those great new theories of physics, biology, economics and sociology that supporters have been hyping — thus boosting social welfare as the Scientific Revolution once did? The answer here is mixed. To the extent that data are needed to test theories and their predictions, then the more the data and the cheaper they are, the better.

However, contrary to what is now widely assumed, data-crunching will not lead to the *discovery* of those great theories that make possible the technological revolutions that engender growth in productivity and living standards. For example, there would have been no electronics revolution had not James Clerk Maxwell deduced from first principles his celebrated equations of electro-magnetism. There would have been no mechanical revolution had not Newton, LaGrange, and others discovered the laws of motion and mechanics. There would have been no computer revolution had not John von Neumann and his associates developed their theories of stored program computers, of self-reproducing automata, and of the limitative theorems of mathematical logic.

There would have been no MAD theory of nuclear deterrence without the discoveries of John von Neumann and John F. Nash, Jr. who gave us game theory and the expected utility theorem. There would have been no quantum computing or many other fields of applied physics had not Einstein, Schroedinger, Heisenberg, and Dirac arrived at modern quantum theory. There would be no theory of "supply and demand" analysis or more generally of general economic equilibrium theory without the pioneering theories of Adam Smith, Arrow, and Debreu.

> *The point is that, in arriving at these myriad theories that made so much economic progress possible, the founding fathers cited above rarely utilized inductive logic (data-crunching) to arrive at their great discoveries. Instead, they utilized deductive logic — that is, reasoning from abstract first principles. This logic was first formally introduced 330 years B.C. by Euclid in his axiomatization of plane geometry.*

Thus when you read the journal papers in which these remarkable theories were first published, you rarely see any data analysis *per se*. Rather, everything is deduced in the abstract from axioms, aka first principles. Subsequent to the advent of such theories, data were generated and analyzed to *test* the predictions of the new theories. Good theories based upon good axioms came first, and generated predictions which subsequently proved true according to data analysis and hypothesis testing.

Today's Pedagogical Crisis: Our concern today is that younger students are being told that they can data-crunch their way to the truth. Most of them barely know the difference between induction and deduction, and few comprehend that deductive logic can be infinitely more powerful in truth-seeking than inductive logic. Too many students believe that, armed with enough data dumps and spreadsheets, they really can discover new theories. This is particularly true today in the social sciences, economics, and worst of all, finance.

But it is well known within the philosophy of science that we cannot crunch our way to the truth. To begin with, data analysis will only provide good forecasting tools if the random process generating the data possesses the three properties of *stationarity*, *observability* and *identifiability*. Real-world random processes virtually never possess all these attributes. For example, structural changes (non-stationarities) such as global warming or the rise of China or the advent of derivatives render historical data problematic in arriving at good forecasting models for the future.

In the case of observability, the variables needed by a good theory often cannot be observed. For example, in game theory, John F. Nash, Jr. showed in 1950 that the outcome of rational bargaining by two parties with opposing interests can only be predicted by knowing the *relative risk aversion* of the parties involved. Yet this variable cannot be observed and thus cannot play its required role in a meaningful data analysis of bargaining.

In market economics, those supply and demand curves required for future price forecasting cannot usually be determined from the data unless certain “identifiability conditions” of an algebraic nature happen to be satisfied. This is another way of saying that advances in pure theory (the Hurwicz-Koopmans-Simon theory of identifiability) were required in order to ascertain when and whether real-world data on historical prices and quantities could be used to identify the true supply and demand curves of the market in question.

Within finance, it is often stated that such-and-such a trading rule is no longer useful because enough traders have learned about the rule and have thus arbitraged away its usefulness. This conclusion is highly problematic. For what often happens is that the trading environment changes due to structural changes which render yesterday’s trading opportunity invalid tomorrow. What “enough traders know” becomes irrelevant.

Conclusion: The notion that the advent of Big Data will be a game changer, generating both additional economic growth *and* fundamental new theories, is problematic. To be sure, intelligence agencies, e-marketers and others will gain significantly from ever more plentiful and inexpensive data. But in higher-level applications, *what will matter is a superior interpretation of data*. This in turn is only possible if we have ever better theories *permitting* a superior interpretation of the data. Regrettably, the advent of superior theories is not governed by the amount of data available, but rather by the advent of conceptual revolutions on the part of true thinkers who utilize the power of deductive logic.

In economics, we are currently ending up in a world where “quants” completely fail to understand this point, and are blinded by the availability of ever more data. Due to non-stationarities of many kinds, these data often tell no story at all, notwithstanding the alleged “relationships” and “anomalies” they supposedly make it possible to “identify.”

4. Emergent Dark Truths about China

No one really knows what China's growth rate is, but there is accumulating evidence that it has slowed more than Chinese officials admit, and that the economy's heralded rebound in growth is a chimera. Nothing is surprising about what is going on; an economic experiment such as China's is likely to end badly if it rests upon poor foundations. In this regard, some very troubling developments stemming from very problematic foundations are besetting China, not to mention Russia and other BRIC nations.

Indeed, one of the big stories in today's press is that the widely held expectation that the BRICs would lead the world recovery is proving false. For growth in many BRICs is slowing down, just as recovery is beginning throughout stodgier OECD nations.

In this brief analysis, we just wish to review several reasons why the Chinese economy may fail to live up to its expectations during the next two decades — reasons that far transcend China's over-rated demographic challenges. We shall not explore the implications of these findings for other emergent economies, but in many cases it is straightforward to extrapolate our analysis of China to economies elsewhere.

Prerequisites for Emerging Market Success: Consider what is required both in the textbook and in the data for a nation to achieve a high level of long-term growth.

First and most importantly, a healthy incentive structure is required. A sound legal system is by far the most important component of the incentive structure, and has been shown to be the most important variable that explains the rate of long-term growth. Among other things, a high quality legal system is required to fight the corruption that brings down so many emerging economies. But there are other aspects of the incentive structure that are crucial to growth, in particular the regulatory provisions of an economy. In this regard, the more flexible a nation's product and labor markets are, then the higher its growth rate will be. As theory and data prove, "the nation that fires the most hires the most."

What can be said of China's incentive structure? The nation scores terribly in the quality of its legal system. As one minister put it so well, "we have telephone books of laws in today's China. Yet regrettably, we have no respect for the rule of law." That says it all, along with the caveat that it can take centuries to develop a respect for the rule of law. This is particularly true when those in power *benefit* from the lack of the rule of law as do the governors of China, Russia, and many other emergent nations. As for its regulatory structure, China scores reasonably well for a developing nation. There are flexible markets that function efficiently, at least in sectors not under state control.

Second, the next most important prerequisite for rapid long-run growth is that the nation's "model" of economic growth be consistent with the requirements of modern growth theory. Here China has gotten itself into trouble via its mixed capitalist/statist model. China's growth has been predicated on unprecedentedly high levels of investment spending (usually state-directed) and on very strong exports. These have been the two legs of the Chinese growth story. One problem with this strategy is that, if an investment rate of 40% - 50% of GDP is funded by borrowing, *and if the funds are invested in projects of dubious value and negative returns so as to accelerate short-term growth*, then a day of reckoning awaits it in the form of a credit crisis. In recent months, China's credit crisis has become front-page news. We read that new cities such as Shenmu, Ordos, and Fugu are bust and are closing down. Restaurant and hotel proprietors are fleeing their establishments and moving away at night. Who could be surprised?

Regrettably, what we are witnessing is likely to be mere foreplay when compared to what is to come. Over two years ago, when China released its sovereign debt analysis showing that its debt was 19% of GDP, independent analysts at Goldman Sachs updated that figure to nearly 200% once the debt of provincial governments and their banks was included — with allowances made for bad debts. We now hear of estimates in the range of 300%. If this proves true, and a large-scale credit crisis drives Chinese growth into negative territory, chaos could erupt.

As for export growth, by keeping its capital account closed and by rigging its exchange rate, China achieved an explosion of exports and cumulative trade surpluses never before witnessed in any nation. *What few analysts take into account are the long-run costs to China of having done so.* By adhering to an export-led (and investment-driven) growth strategy, China by definition has suppressed consumption which has been arrestingly low for decades at well under 40% of GDP. The problem is that, as a nation gets rich, the theory of optimal resource allocation *requires* that a growing share of output be devoted to consumption. This is partly because a successful export strategy will (should) drive up the value of the nation's labor costs and exchange rate, making its exports less competitive. Thus consumption should displace exporting.

Looked at differently, as citizens become more prosperous, they *want* to live better and to go see the Eiffel tower. But the paranoid Chinese government has refused to let such textbook economic logic play out. As a result, the share of GDP dedicated to consumption has remained stagnant at a very low level. This might be all right were it not for the fact that Chinese wages have risen a lot and have thus made China's export strategy increasingly problematic. To plug the gap (as during the global financial crisis when exports fell off), China was forced to rely on massive domestic investment to keep people at work. A decade ago, the government's plan was for investment to fall to about 37% of GDP by today. Instead, it is sky-high at about 48% of GDP.

To conclude, China's model of long-term growth is at odds with the most fundamental precepts of growth theory, and this bodes ill for the future.

The Political Response — the Xi Problem: Given the prospect of lower growth and civil unrest, can China's repressive political system reform itself? Will it shift towards a respect for the rule of law? Will rent-seeking politically well-connected individuals and businesses stop receiving those below-market loans whose funds are either poorly invested or simply stolen? Will the government acknowledge the inherent inefficiency and corruptibility of those state-owned enterprises that increasingly dominate the Chinese economy?

The answer is that such reforms are becoming *less* likely, not more likely. There are two reasons why. *First*, the reforms that are needed run afoul of the self interest of those "princelings" and other Communist Party members who run the show. Second, and perhaps more ominous, China's new leader President Xi Jinping is openly reverting to a Maoist ideology which stresses centralized control and the stifling of all dissent. While his strong Maoist upbringing has long been acknowledged, few expected what has occurred during the brief period since his election.

Consider Xi's April 2013 directive (known as Document 9) that officials combat the "seven serious problems" including press freedom (the very concept of 'civil society'), the heresy of 'universal values,' and the pretension of 'judicial independence.' *Does this not say it all?* The accelerating detainment and arrest of civil dissidents now taking place is just one manifestation of this Maoist reorientation. So is the yearlong campaign President Xi launched a month ago to strengthen and purify the Communist Party — a campaign that observers liken to Mao's "rectification" movements to purge rivals and to enforce ideological discipline.

The cynical interpretation here is that China's leaders know that the economy is in much deeper trouble than they have admitted, and that civil unrest will result. If and when it does, Xi's Maoism will incline him to deal very harshly with those involved. Could there be dozens of future Tiananmen Squares in the future, with press coverage proscribed as in the original Tiananmen massacre? We must never forget Mao's dictum that "power comes out of the mouth of a gun."

To conclude, the investment category of "emerging markets" should be replaced by two categories: emerging markets in nations governed by the rule of law, and emerging markets in nations devoid of the rule of law. Both economic theory and real world experience make clear that economies of the second type will not do well in the long run. The tragedy in the case of China is that the nation possesses a wonderful asset that could end up being wasted: a huge workforce of entrepreneurial, hard-working, highly intelligent people who would flourish in societies with a better incentive structure such as those found in Hong Kong, Singapore, Taiwan, and South Korea.

5. The Disgrace of the Obama Administration's Economic Policies

Many have been critical of President Obama's economic strategy for reviving the economy. Trillions of dollars of national debt have been racked up with virtually no productive investment to show for it, much less to generate future revenues to pay back what has been borrowed. The president has shown little if any follow-through on most of his "initiatives," leaving all details to Congress as he did with his $800 billion stimulus bill, and with ObamaCare.

In the latter case, the president has had nothing to say about the grave problems besetting the start-up of ObamaCare. No one seems to know what is going on with respect to the requisite healthcare exchange market. No one knows whose insurance premiums will rise or fall, much less by how much. No one can hope for a cap on total out-of-pocket healthcare costs since this crucial provision of his new plan has now been gutted — at least temporarily. With only months to go before ObamaCare kicks in, the President remains strangely silent upon these issues. Yet he had plenty of time for an extended $100 million junket to Africa.

Then there was the *de facto* firing of Fed Chairman Bernanke which was handled as disgracefully as was his previous firing of Greg Craig, his erstwhile General Counsel in the White House. In Bernanke's case, this was not an appropriate exit for the person who arguably prevented a complete collapse of the US economy in our hour of need. Finally, consider the absence of any serious economic thinkers who could better advise the President during his second term, notwithstanding a continuing U-6 unemployment rate of about 14% that constitutes one of the gravest economic problems the nation has confronted in recent decades. So who do we get to help extricate us from this stagnation? The appointment of Jacob Lew as the new Secretary of Treasury, an economic non-entity who has said nothing notable since taking office.

The nation needs true economic leadership. Recall FDR's "fireside talks" in the mid-1930s. Recall JFK's creation of the Council of Economic Advisors the moment he entered the White House in January 1961 during a shallow recession. Both Roosevelt and Kennedy sought to surround themselves with "the best and the brightest" they could find. How different our current President is. He seems ever more detached from his job and his responsibilities. If President George W. Bush is criticized for having been "incurious," what adjective defines this President?

Jobs and the IRS Directive: When Obama returned from Africa, he turned (yet again) to the economy, and to the issue of jobs, as if these had not been pressing problems since the day he entered office in his first term. He stressed the importance of job creation by small businesses, and promised to do something about the problem.

He delivered on his promise all right and created a job: he had the IRS send out 25,000 notices to small business proprietors that they were being scrutinized for not declaring all their income. And this was only the beginning. Hundreds of thousands more such notices are soon to be sent out. *What a great way to motivate small businesses to hire!* To begin with, small businesses are now living in dread of discovering how much medical insurance premiums will rise due to ObamaCare. So now they can expect more frequent tax audits — notwithstanding the fact that profits from small closely-held businesses have *effective* tax rates *triple* those paid by big corporations. Ever more frequent IRS notices are not what the doctor orders to stimulate small business hiring — especially in a time of subpar growth.

Are we alone in believing this degree of economic idiocy to be actionable?