Economic & Market Update, October, 2014

The World Economy

By Richard Morey

For the last three months these reports have been focused on the fact economies cannot grow sustainably when debt exceeds a certain level. The crisis of 2008-2009 was caused by too much bad debt – a fact nobody disputes. However, since that time total debt in the world has exploded higher, *increasing by over 40% in the last five+ years*. And as history would have so clearly predicted, year after year we find our economy growing far below its longer-term average. At the beginning of each year our government, and those in Europe and Japan, are sure this will be the year we attain "escape velocity," defined as a substantially higher growth rate sufficient to get our economy growing at "normal" rates sustainably going forward. Each year they are wrong. If history is our guide, this could actually continue for another 15 years!

Please note there are other ways for our nation to proceed economically. Specifically, we could pursue policies designed to encourage our citizens to spend less today and instead save more. We could then simultaneously embark on serious fiscal policies designed to encourage small business creation (or at least remove the roadblocks), *as small businesses create two-thirds of all new jobs*. There are many, many ways our government could work to encourage small business creation and expansion.

Unfortunately, since 2009 Congress has really not done one single thing of substance to assist small businesses. Again, these are the companies that are responsible for two-thirds of all new jobs. In fact, at this time we have the smallest percentage of new businesses being created in history, and by history I mean since we declared independence from England. This is disturbing but not surprising, as all of our government and Central Bank policies are designed to prop up and enrich the status quo, especially the banks and largest corporations.

Going back to the debt problem, our politicians are not completely ignorant (I hope!). They know that decreasing debt always leads to short-term economic pain. Every dollar not borrowed and spent, and every dollar used to pay off debt, is a dollar that could have been used to stimulate the economy today. But when your debts are so high you simply cannot pile on more and possibly pay it off in the future, you then must reduce your spending. However, no politician wants to recommend anything that leads to short-term pain. Instead, they want to be able to tell voters their policies will allow them to be more prosperous, i.e. spend more money, right now.

So history says we will have low growth until we get our debt levels cut dramatically, but our nation has been following the path that has always led to low growth for a very long time. There is, however, one new wrinkle the Fed has done to try to get our economy growing, which is to print approximately $4 trillion of new money. This is an experiment which by now we can see has clearly failed. In fact, it has failed so miserably the Fed itself recently downgraded their growth expectations for the next two years to below 3%. This is shocking, as they themselves have consistently said GDP growth of 2% is "stall speed," meaning it is a rate so low as to easily deteriorate into recession.

When the Fed began printing money they said it would lower interest rates, thereby stimulating lending and lead to economic expansion. They failed on this measure. It is true many of our corporations have borrowed huge amounts of money at low rates, but most of that money has been used to buy back their own stock (at inflated prices). What we have not seen is banks aggressively lending money to businesses wishing to expand or start new businesses. I mentioned new business creation is at an all-time low. Similarly, capital expenditures which are investments companies make to expand, have not risen since 2000 and are at historically low rates. Since these are basically the only ways new good jobs are created, the Fed's money-printing has definitely failed in their primary stated purpose.

After they began printing the Fed said another purpose was to get stock prices higher, and they have certainly succeeded on this metric. Money-printing has led to higher stock prices in several ways. One was mentioned previously – corporations have borrowed a lot of this money at low rates to purchase back their own stock. Another way money-printing has lifted stock prices involves the activities of the banks themselves. Instead of lending out the money, they have invested it in a wide variety of risky assets, including stocks. Finally, by keeping short-term interest rates low, the Fed has managed to "force" many investors to take their money in savings accounts and CDs to purchase stocks. Of course, "forcing" older citizens to dramatically increase their risk level just so they can try to survive when CDs are paying practically nothing is a questionable approach. Personally I find it immoral to do so, a fact that will come home to roost when those poor older investors end up losing a substantial portion of the money they really needed to keep safe.

So money-printing has been good for the stock market. When stating this as a goal of their printing program, the Fed said a rising stock market would make people feel better off so they would then spend more money, thereby increasing economic growth. I thought this was quite an odd statement when they first made it, as numerous studies have proven rising stock prices do almost nothing for the broad economy. People spend more money when they earn more money from work, as they can depend on receiving a regular paycheck. But investors know their stock gains can disappear quite quickly, so they spend little more when stocks in their brokerage accounts rise in value on paper. One solid study showed a 10% rise in stock prices leads to an increase in economic growth by one-tenth of one percent. Even this increase is, however, transitory. Clearly the unknown but potentially large risks involved in printing $4 trillion outweighs the small short-term increase in spending connected to rising stock prices.

So far we have only been looking at the U.S. economy. And while our debt levels are very clearly far too high for us to *ever* achieve decent economic growth until corrected, if the U.S. was the only country in the world we *might* be able to get through our difficulties relatively unscathed. The U.S. stock market would still end up far, far lower than it is today – because it is historically overpriced – but most of our other problems could perhaps be solved over time. Unfortunately we are not the only country in the world, and the other three main economies – the Eurozone, Japan and China – are presently in much worse shape than we are. The Eurozone remains one German constitutional court decision from breaking up, or one election in which a "Euro skeptic" wins and that country withdraws from the Eurozone. Should that occur, we are absolutely guaranteed to have another worldwide financial crisis. Their banks on whole remain insolvent (i.e. bankrupt), unemployment remains right near an all-time high, and they are in danger of losing an entire generation of young workers who never get their careers started. The government debts which nearly brought them to full crisis mode have gotten larger, not smaller. Plus, the Eurozone appears to be entering their third recession in the last six years. Their situation remains so negative and precarious that having at least one country leave remains a very serious possibility. Again, should that occur we will have a full-fledged worldwide financial crisis. Just as troubling, if you study all of their proposals, you would be hard-pressed to find *anyone* in power who has any viable solutions to their terrible economic challenges.

Most expect Europe's next move to be quantitative easing, i.e. printing money as we have done so well here in the United States (sarcasm intended!). There are two problems with this idea. First, it doesn't work to increase economic growth. We have seen this now for several years in the U.S., and it would do even less in Europe. This is because businesses in Europe have even less interest in borrowing more money to expand than they do here, as the Eurozone consumers are in no position to increase their spending.

There is one other small problem with embarking on money-printing in the Eurozone: It is blatantly illegal. They can talk about it, and over the last 2+ years the ECB's head Mario Draghi has been able to keep the crisis from re-erupting only by saying he will do anything he thinks is necessary. However, if he actually tried to follow through on his words there is a high probability the German Constitutional Court would veto his plans. This becomes more likely each day, as a new political party (the Alternative for Germany or AfD party) is quickly gaining support in Germany – a party whose platform calls for not a penny more in bailouts and for Germany to discontinue using the Euro as their currency.

The situation is much worse in Japan, as evidenced by the fact their economy shrank by *over 7%* last quarter. They may be on their death throes, and they now have exactly one option to pursue. They are going to print up to a *quadrillion* yen to pay off their government debts. Their debts are far, far, far too high for them to ever pay them off. By simply printing all the money needed to pay back the money they borrowed, everybody will indeed get back the exact number of yen they loaned their government. However, as a result the yen will eventually collapse, dropping from 108 yen to the U.S. dollar to 200 or even 300. With yen being worth less and less, this means everything they import is going to skyrocket in price. Being an island, Japan is in the difficult position of needing to import much of what they need to live. So their citizens who loaned money to their government will indeed get those yen back, but those same yen will end up purchasing only a fraction of what they did before Japan prints all the money to pay back the loans.

I won't go into China's problems again in detail here, except to say they now hold the record in new debt creation, having increased total debt in their entire nation by over 150% in only five years! Most of this money went into real estate development, resulting in a bubble of epic proportions. Now the bright economists who run China know they are in a precarious, dangerous situation. In response, earlier this year they decided they simply had to slow down the real estate market, so they began to withdraw the money available to build more. Their hope was that they could thereby let the air out of their real estate bubble slowly over a period of years. Now I have not been able to find one example in the history of world economics in which a true bubble shrank in a slow and orderly fashion over years, but if anybody could accomplish this it might be China. This is due to the fact they have very bright economists who can exercise an unusual amount of control over their economy, plus they have several trillion dollars of money in reserve (mostly U.S. bonds) to bail out their banks without going into debt. I was quite skeptical the Chinese would be the first to deflate a true bubble in a slow and orderly fashion, but still thought it not impossible they would succeed.

They failed. Real estate began to drop much faster than they hoped. With so much of their total national wealth in real estate, this meant their entire economy and financial system was in danger. It now looks as if they are "throwing in the towel" on trying to let the air out of their real estate bubble and get to some semblance of economic balance. Last week it was announced they are going to replace the prudent head of their central bank with someone who will have been ordered to lend more money into real estate development. Since a fairly large amount of the previous real estate investments are already non-productive (meaning the companies involved would have to declare bankruptcy if they were ever forced to repay their loans), adding more fuel to this fire will almost certainly end in financial crisis. In essence, they are adopting the same policy the other major economies are pursuing: Print or lend massive amounts of new money and pray a miracle will occur if given enough time – the miracle being that somehow debt which should never have been created in the first place will turn out to be productive instead of a total loss of principal.

Summary

While we are truly in unchartered macroeconomic territory, we can safely come to four conclusions:

1) An economy cannot grow its way out of a debt crisis by creating more debt. Time does not and indeed cannot alter this fact. To the contrary, following this misguided approach simply makes the "day of reckoning" worse the longer it continues.

2) Printing money does not lead to productive economic growth when companies do not believe investing in their operations will lead to increasing profits (due to weak consumer demand caused by consumers being over-indebted while their incomes stagnate or decline). This applies to the U.S., the Eurozone, and Japan.
3) Forcing banks to lend massive amounts of additional money for real estate development when it is already severely overbuilt and overpriced ultimately leads to larger and larger losses of principal. This is the path China is taking.
4) Countries that print huge sums of new money see their currency fall relative to those who are not printing money. We will explore the economic ramifications of this below.

As stated above, if the United States lived in a vacuum I do believe we would eventually find a way beyond these challenges. Reducing debt always leads to a slower economy, so no matter what path we took to get our nation on solid economic ground, it would entail suffering in the short to intermediate term. But I believe we could turn our ship around.

However, we don't live in a vacuum. To the contrary, our economy is more dependent on the rest of the world than at any previous time in history. Over the last five years exports have accounted for a full 50% of the economic growth we have had in the U.S. This is troubling on two levels. First, the rest of the world economy is definitely slowing down, meaning they now have even less money with which to purchase goods made in the U.S.

Second, although the U.S. has printed approximately $4 trillion, this month the Fed plans to completely stop the printing presses. But the other countries will either be ramping up their printing (Japan) or beginning some version (Eurozone), while China is simply going to directly force their major banks to increase their real estate lending. Printing money leads your currency to fall versus the currency of countries not printing new money. And indeed, the Euro and Yen have now started to fall fairly dramatically versus the U.S. dollar. This makes our exports to those areas more expensive, which jeopardizes our corporations' ability to sell abroad. With half of our previous economic growth due to increasing exports, I'm afraid the troubles confronting the rest of the world are going to diminish our economic growth even further.

My main concern for our citizens is the fact the solution to too much debt actually does entail reducing debt. Although getting down to a sustainable debt level paves the way for real, sustainable economic growth, paying off debt lowers growth while it is occurring. This means any politician who recommends the solution that would actually work will find him or herself out of a job. You simply cannot win an election by telling people they are going to have tough times ahead due to your chosen policies. This means we are unlikely to change from our current destructive course until things get so bad the people demand real solutions.