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## **THE GREAT RECESSION, GLOBAL CONDITIONS FROM WEST TO EAST AND BACK AGAIN: A FORWARD LOOKING COMMENTARY**

### **ABSTRACT**

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This article examines national economies, the processes of the global financial system, the relationship to the expansion of global enterprise and the future. The article describes how the process of global economic integration was largely accomplished by a monetary amplification that supported chronic East-West trade imbalances that are unsustainable. The mechanism for much of the recent global economic growth is identified and shown to be untenable because the consequences of the process eventually results in a subsequent reversal and global contraction. Tracing the reactions in terms of who assumes the costs and who receives the benefits helps to illuminate the nature of the process and the subsequent failure. The future consequences are examined, contrasting policies are compared and recommendations for solving the problems are offered.

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*Key Words: finance, growth, money, recession, policy*

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## INTRODUCTION

During the preparation of this article, the world is in a deepening recession because the business model of globalization is faltering. The economic system based upon production in the East and consumption in the West has broken down. In this article, the authors will not only review the details of what has transpired, but venture into the future. Academic publication takes time, the process moves rather leisurely, but the global economy is moving very quickly as extraordinary events change conditions rapidly. Therefore, to be of better service to readers, the authors have attempted to look forward.

With the economies of developed countries in recession and most of the less developed nations quickly falling, annual worldwide growth is expected to be reported as negative for 2009. The official estimate of the U.S. fourth quarter of 2008 revealed a very weak performance in the U.S., showing GDP growth at a negative 6.2 percent annual rate, from a steep contraction in personal consumption and private domestic investment and the first quarter showed a negative rate at 6.1 (Bureau of Economic Analysis 2009). This contraction constituted the worst upset since the depression of the 1930s, although not as severe it may come to be known as the “great recession” or by some other distinctive term of economic decline. Indeed, there are parallels between the depression of the 1930s and now, but there are also differences. Perhaps most important among the differences are the actions of central banks and government fiscal policies worldwide. Whereas during the Great Depression of the 1930s the central banks’ reactions were not as simulative, the recent financial debacle has seen central banks around the world attempting significant increases in money supplies and other palliative actions to thwart asset deflation. The central banks can do this because money is no longer officially tied to gold or any physical commodity, and can therefore be expanded by simple decree (Solomon 1982). This is an attempt by the banking community and governments to re-inflate asset values that have been declining, and the process has been used before (Shelton 1994). However, it is important to acknowledge that the real value of any asset is the net present value of the future income streams that those assets can create. The value is not the inflated asset price of the past, but the size and time period of future cash flows. Nevertheless, the policy chosen has been an attempt to disguise the real value in order to match the formerly inflated prices; re-inflation, with the idea that the policy would stop the further decline of market values (Rodrik 2003).

The sheer size of the potential for debt de-leveraging overwhelmed central bank actions in 2008. Central banks of all the developed economies participated in numerous liquidity enhancements. The most aggressive monetary response has been undertaken by the U.S. Federal Reserve banking corporation and U. S. Treasury. Together they have taken unprecedented action to remove many of the debts from bank's balance sheets, in the hopes that this action would prove to be strong enough to reverse the course of decline. Nevertheless, such actions are simply switching debt defaults from the private sector to the public sector and increasing the debt of federal government. That is not a long-term resolution, but only a temporary palliative prescription. All the same, despite the large monetary and fiscal actions, the United States output will probably contract each quarter throughout 2009 and average a negative 4 percent. Canada can also be expected to remain in a recession during 2009. Mexico's downward slide is exacerbated by advancing corruption that will continue to unravel its economy. United Kingdom's GDP could very well be reported as somewhere around minus four or more percent by year-end. Likewise, the EU may be expected to suffer continued contraction, while Eastern European countries also suffer steep declines in 2009. Latvia, Lithuania, Bulgaria, Ukraine and Romania are countries that will suffer significantly from their relatively large current-account deficits. The European banking system will prove to be weaker than the U.S. and face greater losses from lending to the Eastern block. The European Union's office of statistics reported the largest decline in employment on record in the first quarter of this year (Eurostat 2009).

Australia and New Zealand can be expected to remain in recession throughout 2009. Latin American countries will face a serious slowdown in economic performance, with postponements of major investment projects in both the public and private sector. Russia can be expected to contract with a similar percentage decrease as in the United Kingdom. China will experience a significant slowdown and the growth in GDP could be closer to half its previous highest growth rate, without counting their government stimulus. Nonetheless, the Chinese government's stimulus-plan appears well conceived and it should moderate the impact of global financial 'fallout' (China.org.cn 2008). China's domestic consumption is increasing to fill some of the gap created by decreasing exports. For example, the Chinese are purchasing automobiles made in China at a rapid pace, making them the largest auto market. Nevertheless, the overall growth rate of their economy will experience a significant decrease. India's growth rate will also decrease. Singapore

estimated that their seasonally adjusted real GDP fell by a shocking 12.5% in the 4<sup>th</sup> quarter of 2008, and the expectation is a more serious contraction in 2009 (Singapore Ministry of Trade 2009).

### **THE REASON FOR CONTRACTION**

The primary reason for these events is because the business model of production in the East and consumption in the West could not expand forever, it was logically impossible; the trade imbalances eventually became too large. The mechanism upholding the imbalances was a complex system of financial instruments that artificially valued global assets. The details of the financial artifice have been reported elsewhere, repeatedly, but the larger perspective is addressed here and the imperatives related to this phenomenon disclosed. Essentially, the cause underlying the advent of the great recession was an enormous artificial expansion of the global money supply, achieved partly outside of the official central banks, but acting the same as direct increases in money supplies, and therefore it has been very inflationary. The highly leveraged debt-backed securities, which became known as “toxic assets,” were essentially new monies, which increased apparent purchasing power, but eventually lost marketability when a speculative reversal took hold and caused a financial meltdown.

Scholars worldwide must wonder how anyone believed in the so-called “decoupling theory” (The Economist 2008). Such an idea was contrary to the reality of global integration. Decoupling was a curious idea. It makes no sense to imagine that the fates of national economies are unrelated. All nations share the same planet. They were never wholly unrelated and countries everywhere are definitely affected by the economic health of the United States, since it is the world’s largest national economy and independently constitutes a fifth of all GDP. The European Union is approximately equal in economic measure, and these two regions comprise the Western developed economies. Whatever happens in the West affects the East and vice versa because the economies worldwide have become significantly intertwined. The magnitudes of trade deficits of the United States were extremely large and this is evidence of the significant linkage with the Eastern nations who were experiencing consequent trade surpluses. Furthermore, the international system supports the U.S. dollar as the world’s reserve currency as a financial linkage with the global economy. Decoupling is not the issue, although less dependency is a possibility.

Moreover, the trade imbalances of the U.S. persist because the industrial activities are spread unevenly, causing a structural dependence that is untenable. As long as a comparative advantage of labor supply in the East exists, there will be a self-defeating imbalance in trade or movement to less trade. The U.S. cannot continue ad infinitum consuming more than it produces for export, and likewise Asia cannot continue to export more than it imports. Whether the logic of national economies is described in flow diagrams or expressed in the equations of national transaction, the logic is consequential and irrefutable. For example, the common notation for a national economy is in the expression:

$$Y = C + I + G + X_n \quad (1)$$

where  $Y$  stands for gross domestic product,  $C$  is consumer spending,  $G$  is government spending,  $I$  is domestic investment in productive equipment and facilities, and  $X_n$  is exports minus imports (net exports). Subtracting  $C$  and  $G$  from both sides of the equation reveals:

$$Y - C - G = I + X_n \quad (2)$$

The two terms on the right side of the equation are the important determinants of the type of economic future that will take place because investment in domestic plant and modern productive equipment is the variable that will determine future productivity and consequently the overall standard of living for the citizens. It is undeniable. Moreover, chronic negative net exports, as the U.S. has experienced for many years, actually involves selling ownership claims on America's real national assets precisely because it is further debt owed to foreigners. Such persistent trade deficits cripple a national economy, but this is often overlooked by economic commentators and the non-academic business press. Chronic trade deficits must eventually lead to national insolvency an equivalence of bankruptcy where the major creditors purchase ownership of the debtor nation's real assets instead of holding its government securities.

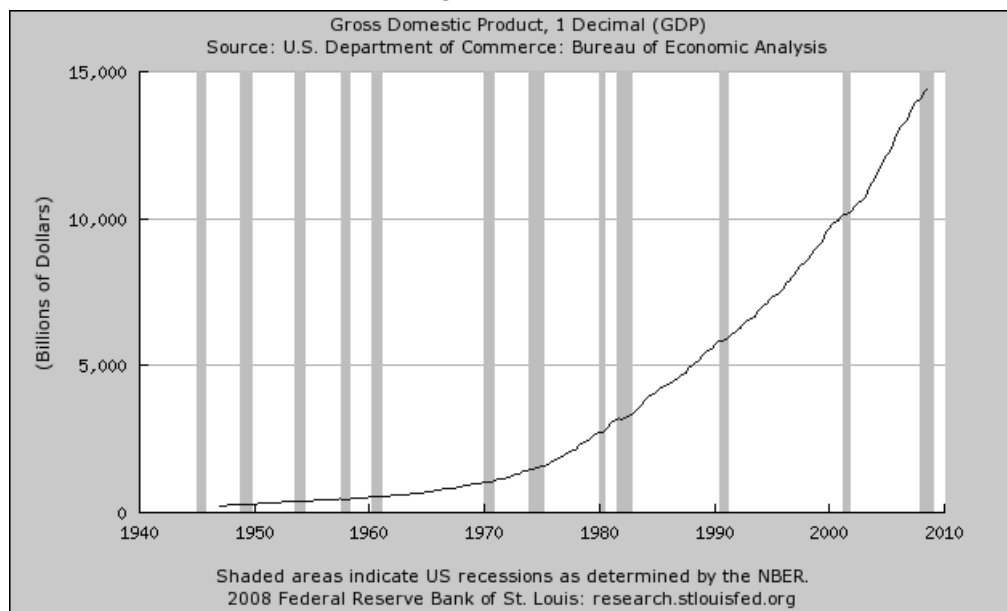
As the equation number 2 clearly illustrates, imports are financial leakages from an economy and exports produce financial inflows to an economy. In the end, these flows must be balanced. Otherwise, one economy is consistently losing while another is gaining. Even if we imagined a single economy with a single currency, a one-world economy, the outcome is not changed; it simply means that one region of the global economy gains while another region loses. From the perspective of nation states, the political identification does not change the outcome; the only caveat would be if the imports

significantly contribute to some sort of long-term productive advantage to the country experiencing a trade deficit. Nonetheless, empirically, this theoretical exception has not been the case in developed economies, particularly the United States. Year after year, these imbalances have grown to untenable levels but there has not been a long-term productive advantage to developed nations that run chronic deficits of sizable proportions. These are important realities that have been overlooked and not adjudged in national policies.

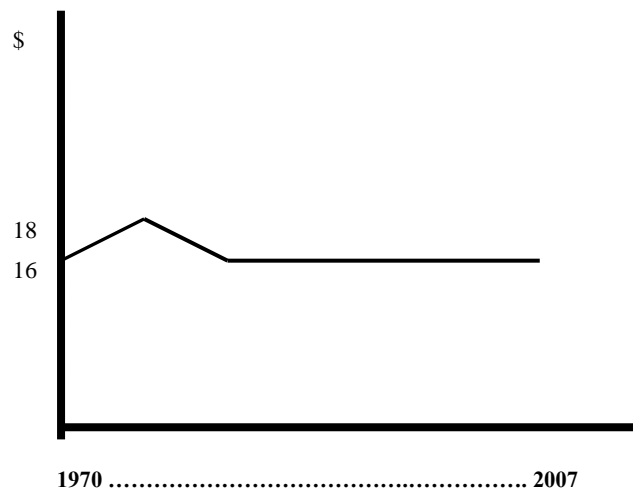
### EXAMINING THE BACKGROUND OF ECONOMIC CRISIS

It was generally accepted that Americans were increasingly better off in the late 20<sup>th</sup> and early 21<sup>st</sup> Century. Was that idea of America a reality? A casual glance at the nominal historical GDP would appear to support this proposition.

**Figure 1: US GDP**



However, if we look at the wage data and adjust it for inflation, we see a different story. Figure 2 illustrates the median hourly wages of workers from 1970 to 2007.

**Figure 2: US hourly earnings 1970 - 2007 (in constant dollars)**

Source: estimates based on U.S. Department of Labor data, Bureau of Labor Statistics

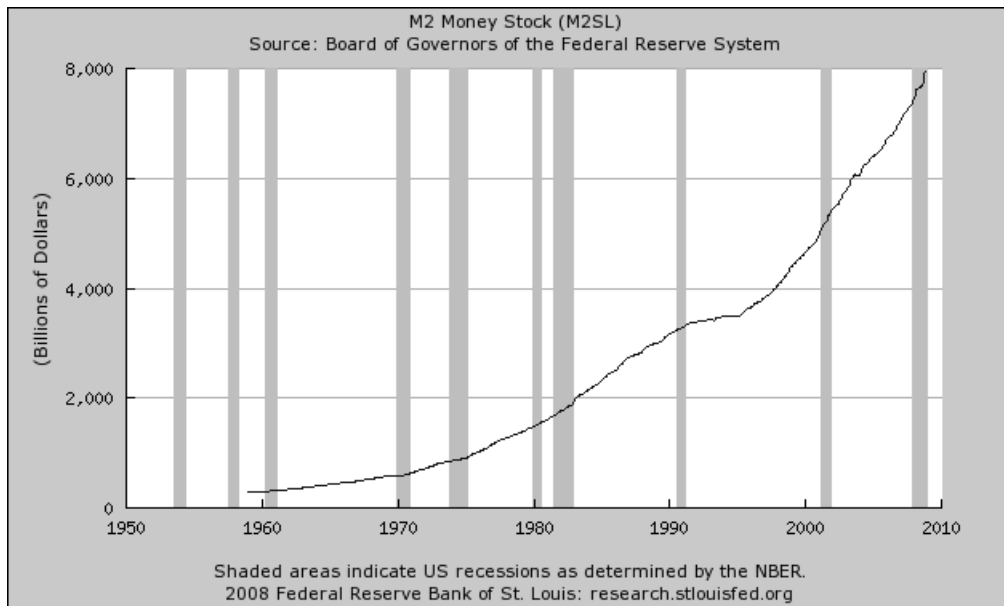
The median hourly wages in 1970 (adjusted for CPI) stood at \$16 in current dollars, and rose to \$18 three years later and then immediately retreated again. From 1980 to 2007, wages continued to be stagnant and stood at the same wage rate as thirty-seven years earlier, \$16 an hour, according to archival data of the U.S. Department of Labor, adjusted for inflation. In other words, over this thirty-seven year period there was no real significant increase of median hourly wages. Furthermore, after 2003 the weekly earnings of workers with a bachelor's degree fell by 6 percent (Mandel 2008).

The U.S. experience is very interesting. The answer as to how the per-capita income could be growing while real wages were largely stagnant is that there was increasing income inequality. Moreover, many families had become two income earners in order to maintain a standard of living. Increasing consumption of most citizens was made possible by accumulation of debt rather than by income. Most people were not really "better off," unless the data is fudged by assuming that people were better-off because they could go into debt in order to buy new products that did not exist in decades past. Things such as the ubiquitous flat screen TVs, cell phones, microwave ovens, and various extraneous gadgets. It is only by growing debt that the majority of Americans experienced a higher level of consumerism. The apparent affluence was due to increasing indebtedness, owed increasingly to foreign entities because of huge trade deficits. The U.S. experience of income and spending patterns is illuminating. Those individuals that fall within the first

two quintiles of income were spending far beyond their incomes (U.S. Department of Labor 2005).

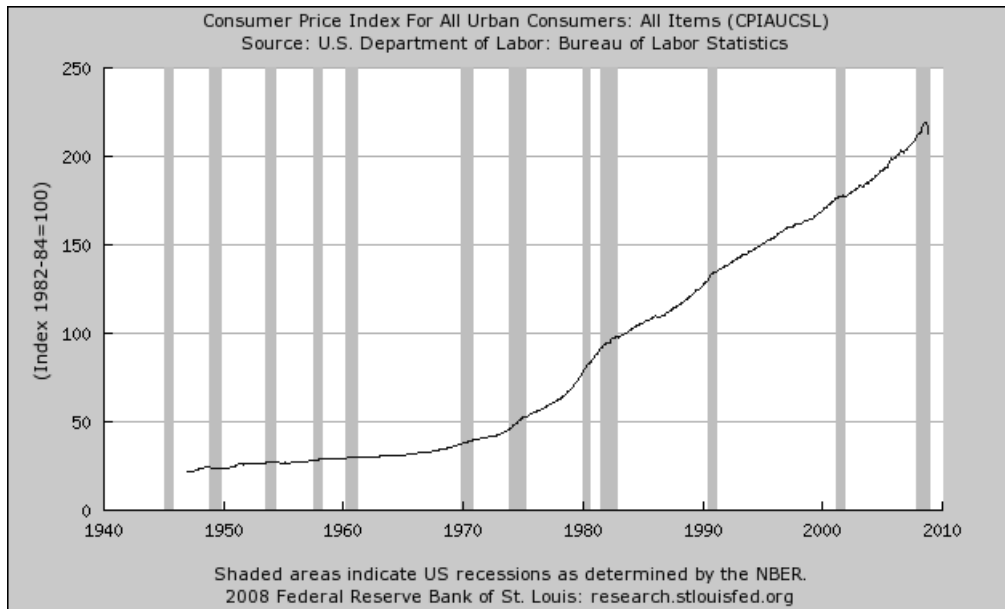
Consider the meaning of the following graph where after 1975 and particularly after 1995 the money supply grew far faster than productivity of the real economy (Figure 3).

**Figure 3: Historical M2 money supply**



This growth in the money supply was *inflationary* as shown in the official consumer price index in Figure 4. The rising money supply coincides with the inflation and consequent rising of nominal GDP. When the reported growth of the economy is considered, and the inflation is removed, there has not been any appreciable real growth in the GDP; it is largely a *monetary illusion* (Figure 4).



**Figure 4: Historical CPI**

In the year 2007, the worldwide-inflated stock markets were ripe for serious decline. The signaling effect was the reversal of the rising real estate market and the fallout from the mortgage fiasco. However, all of this was built upon a shaky financial foundation that had been designed to spur the creation of global growth by leveraging assets to produce purchasing power and vastly increasing debt. This was an unsustainable process waiting for the time when servicing many of these intractable debts would become impossible. Stock markets experienced a similar run-up before the inflation of real estate, and subsequently commodities of various types followed in sequence. Inflated valuations of the securities markets, real estate markets and commodity markets were the so-called “asset bubbles” that formed as new money chased after the latest financial fashion, leaping from one to another. As asset bubbles are created through competition for capital, only those individuals who exit before the next crash can be winners. Some of the winners were the extremely well compensated American CEOs that were consistently taking billions of dollars of financial capital out of the companies in which they were employed, and further contributing to the rise in inequality and thereby decreasing the average consumer’s ability to purchase. Credit was increasingly made available to the general public to ease the gap between income and consumer spending.

Why has there been a financial rollercoaster traumatizing individual economies and shaking the entire global financial system? The answer is revealed by tracing how the so-called asset bubbles developed and burst. Investors are attracted by opportunities for profit, which may result from economic growth. In the aggregate, growth in less developed economies can be initiated by investing surplus capital from developed nations into less developed. This is a practice that can be accomplished by transferring savings from developed economies. However, surplus financial capital need not only come from real savings but it can arise by increasing the money supplies of the developed nations thereby inflating the economies of other nations. If it is real savings that are transferred out of the developed economies, it lowers opportunities in the developed countries, but increases opportunity in the less developed countries. However, if instead, the process is initiated by an artificial expansion of the money supply, it can only work by a temporary illusion — an illusion that new aggregate wealth has been created.

The artificial expansion of the money supply results in what may be termed “cheap money” created when interest rates are below the rate of general price increases. The global economy has been subject to a continuing process of general price inflation, followed by asset deflations as speculative decisions reverse and over-valuations collapse. Recently, various asset-classes encountered reversals, which erupted in the worst global financial crisis in recent history. The most obvious example has been the global collapse of inflated housing prices. It occurred because there was a swiftly advancing artificial expansion of the money supply exacerbated by over abundance of credit, which caused a rapid rise in prices of housing. Wages were not increasing, therefore access to credit was increasingly extended to the general public in order to increase demand for housing and consumer products beyond the ability to pay from income.

## **THE ROLE OF THE FINANCIAL INVESTMENT FIRMS**

Homebuyers and mortgage lenders were not the only ones using debt financing and so-called ‘cheap-money.’ More importantly, private equity investors borrowed and leveraged huge amounts of money in order to acquire and control large corporations. Hedge funds, pension funds, insurance companies and private-equity investment groups borrowed from financial institutions that in turn borrowed from foreign entities. With the new money, these speculators went on buying sprees. They accumulated stocks, real estate and commodities. They purchased far more than they could afford to buy with their own

money. They borrowed directly, and also indirectly using derivatives that were created with borrowed money. This was a growing pyramid of debt; an upside-down pyramid leveraged many times over. Imagine, borrowing 20 to 30 times the value of pledged assets. That leverage, which was a common practice at financial firms such as the former Lehman Brothers as well as many others, allowed massive increases in purchasing power, which subsequently caused huge increases in the prices of assets (Copetas 2008). Financial news headlines carried announcements of the escalating multi-billion dollar acquisitions. This was a rampaging global phenomenon. It gave the appearance of a newly found prosperity.

Where did all the new money come from? Partly it arose from the commercial banking system. However, the larger portion came from financial investment firms that essentially invented a way to create their own money. They increased the supply of money via securities of collateralized debt obligations. By packaging and parceling the financial vehicles and other derivative “products” for investment, they effectively created money; vastly expanding the money supply. These “securities” and offshore conduits have been powerful and dangerous because they constituted forms of new-monies. This is debt-based money that operates to expand economic activity in much the same way as legal tender issued by central banks. It is a form of new-money, backed only on private promises to pay and not by any government. Similar to a nation’s fiat currency, this type of money also arises from the creation of debt. The more debt, the more money was created. However, this was not controlled by any central bank. Instead, it was administered by Goldman Sachs, Lemman Brothers, J. P. Morgan and the other the investment firms. That is why the effective money supply increased rapidly and there are now many billionaires and multi-billionaires. A big problem exists because many of the people and the corporate entities originating these underlying debt obligations are not able to satisfy their promises to pay. A debt that cannot be serviced is ultimately worthless, and money based upon such debts is also worthless. In addition to this new-money, many of the developed nations were simultaneously inflating their official money supplies, and the amount of money was growing at a double-digit rate. Furthermore, the growth in the derivative paper amounted to even more than the growth in the official money supplies by tens of trillions of dollars (Shipman 2008).

This unprecedented expansion of the global money supply was the ultimate facilitator of rapid globalization. The U.S. was not alone in this process but it was initially the largest player in this game. There were benefits to the less developed countries, real additions to

employment in the emerging economies, along with greater extraction of natural resources. Huge numbers of new buildings of all types were constructed. This increase in activity was real economic growth, but it is not paid for by previous productive savings. Was it sustainable? The growth was largely purchased by issuing huge amounts of new debt on the future. New employment was underwritten by this illusion. Debt involves a promise to pay and to the extent the debt cannot be repaid, the economic growth must come to a standstill, and the assets must devalue or the economy reverses and then stagnates for many years. In 2008, when the foundation of the mountain of leverage slipped, prices faltered, many paper assets became unmarketable, and this was followed by a de-leveraging process where enormous borrowing unwound. Step by downward step, creditors demanded more collateral on these loans, which caused the borrowers to rush to cover their exposure. The borrowers had to sell quickly before asset prices fell even farther. The rapidly declining asset prices required the creditors to demand even more collateral at every stage of the de-leveraging process. The de-leveraging spreads from one asset class to another. This is a simple reversal of the process that was responsible for building the global price inflation in the first place. The reverse process causes uncertainty of current and future value. No one knows what the assets may be worth tomorrow. The uncertainty causes fear of further loss. Eventually, this type of uncertainty caused the so-called 'credit-crunch' where banks refused to make new loans and simply froze their cash holdings. The global financial crisis morphed into a global currency crisis as the unwinding of foreign borrowing caused huge reversals in foreign exchange transactions, and more uncertainty ensued. The deflating financial markets triggered spiraling contraction in the real physical economy.

## **LESSONS FROM CRISIS AND GLOBALIZATION**

What are the lessons of this global economic misfortune? As we can see, there are many lessons to be learned and in some cases re-learned:

- 1) Behind the crisis was the unsustainable practice of transferring production to foreign nations and suppressing real wages in the West.
- 2) The rate of increase in financial liquidity was far greater than the rate of increase in real productivity. This process also causes capital dislocations and unsustainable trade imbalances (International Monetary Fund 2007). Furthermore,

- because some real capital was removed from developed economies in the West, it lowered the opportunity for real national growth in the developed economies.
- 3) Artificial inflation of currency by debt financing compounds and becomes an additional problem for all the developed countries involved, especially those countries that run trade deficits.
  - 4) The practice of leveraged borrowing is always highly susceptible to the slightest reversal of prices. Moreover, when many people and financial institutions are involved in the frenzy of borrowing and spending, this creates the conditions for cascading de-leveraging and collapse. Unfortunately, this financial unwinding of leveraged debt causes the real physical economy to reverse.
  - 5) The greatest burden falls on those least able to bear the costs — many working-people who lose employment and are added to the roll of those who cannot pay their debts, and consequently the downward spiral continues.
  - 6) The general approach of businesses in the American economy is for corporations to attempt to maximize revenues and minimize costs. However, the constraint on costs has most often focused on the cost of labor and this presents an indefensible economic problem for the macro economy when de-leveraging takes hold. Consumption is the largest engine of the modern economy, but constriction of wages and unemployment constrain consumption dramatically.
  - 7) The model of the contemporary business strategy in the U.S. is to seek growth of sales above all other strategic objectives. Growth of markets and sales is the focus, with little or no consideration regarding the growth of wages; often the companies' end up with unmotivated laborers and very thin profit margins, and this promotes off-shoring jobs to Asia. Consumers, after making their monthly interest and principle payments on past loans, eventually have no money left to support additionally loans and they must discontinue additional purchases. In the short and medium term, individual companies may benefit from off-shoring most everything, but in the long-run, it erodes the economy of the homeland because it is a *fallacy of composition*.
  - 8) Government policies must limit concentration and prevent the development of “too big to fail” scenarios. In the United States, the evisceration of the 1933 banking Act, and deregulation of financial institutions that allowed instruments of

leveraged-securitization to proliferate, was largely responsible for the recent financial crisis.

- 9) The central bank can increase the means of debt effortlessly, but the ability of debtors to pay interest and principle is bound by their income. Invariably a recession ensues and can cascade downward into a deep depression. Referred to as 'business cycles' the prescription has often been monetary and fiscal policy aimed at creating even more debt in an attempt to flood the markets with liquidity and force employment through government spending. This is a process of halting deflation and causing a re-inflation. The lesson of logic is that the prescription is aimed at suppressing symptoms, but solves none of the underlying infirmity within the system, and the disease continues because it does not change the structural problems within the East-West economic model for business. The problem lies within the concept of globalization itself.

## **THE ROLE OF ECONOMIC ANALYSIS**

The discipline of Economics explains everything by way of two fundamental models, micro-economics and macro-economics. The first is concerned with individual markets and the second is focused on nation states. There is no generally accepted mega-economic theory that pulls everything together for analyzing a global economy. However, macroeconomics can explain the outcomes of international activity in terms of gains or losses to the territories or regions or nation states. These analytical tools of economics, taken together, can serve the purpose of global analysis. For example, equations 1 and 2, as earlier presented in this article, predict the outcomes of international transactions and explain the implications for national territories. This is straightforward but of great practical value. An important consideration in the study of global economic activity is whether or not a convergence of income levels between and within countries can be the expected outcome. If convergence is true, then globalization leads to everyone being better off. According to this convergence hypothesis, initially poorer nations grow faster than the more developed nations (Slaughter 1997). Eventually, income per capita is expected to converge, and the gap between the rich and poor nations are greatly moderated (Jaakkola 2007).

An interesting hypothesis, but the reality appears quite different. The United States is a case in point. Acknowledging that GDP in most all countries increased, particularly over

the ten-year period 1997 to 2007, there is a problem because real incomes of the majority of people within in the U.S. had actually been flat or decreasing rather than increasing. This was true for many of the developed economies (Mandel 2008, Pogge 2008). This is illuminating and extremely important. Equally important, income-inequality in the developing economies was also increasing not decreasing, as the wealthy grew richer more rapidly than previously (Pogge 2008). In the U.S., numerous examples became apparent when corporate executives took hundreds of billions of dollars in compensation annually, hedge fund managers grasped even more, amounting to upwards of 22,000 times the average workers income (Shell 2007). Essentially, real wealth of many individuals was expropriated by a relatively small number of people, as the new-money was pumped through the economies of the world. Without the knowledge of most people, real physical wealth was transferred from many to few, which might otherwise be known as theft, but in this case there was no law against it, and nothing innate within the economic theory of markets can prevent it (only an upward boundary of a very high progressive tax rate can prevent it).

These income and wealth distributional effects eventually become a drag on the overall economy. When this process reaches an unsustainable position, the result is a serious depression of real economic activity, because national monetary manipulation cannot avert the eventual failure of financial illusion; debt cannot continue to grow unimpeded. In only a few years, the U.S. government along with the major financial institutions indentured the nation with over \$4 trillion of foreign debt, and private investment companies had created even more trillions of dollars of private debt, supposedly collateralized. This fact was temporarily hidden within the inflated housing prices and accounting practices, but real-wages of the majority of workers were insufficient to maintain service of this debt, and therefore a general wealth erosion of the average citizen had actually taken place. More important, the U.S. was not alone. These IOUs of the developed nations, the new money, had temporarily spurred rapid industrial growth in the less-developed nations such as India, China, Vietnam and others. The new wealth of these nations is largely owned by relatively few individuals and the foreign holdings of debt constitute the ownership claims on assets and resources of the citizenry of the developed nations (e.g., foreign claims on the EU, GB and the USA).

The highly touted miracle of globalization did actually benefit some of the poorer masses in the developing nations but it greatly enriched a few privileged people. It was

much more a transfer of wealth than a creation of new wealth. The new-money based on debt instruments was structured much like an infamous Ponzi scheme and therefore unsustainable. The pyramid of debt-money eventually unravels and most people suffer. All of this is predictable and macro-economic analysis explains the phenomena in terms of nation states and global regions. What the theory and models cannot forecast is the exact time of the economic reversal, but the analytical tools of economics do predict the ultimate outcome of the unsustainable conditions.

### **PERSPECTIVE**

In mid 2009, a U.S. government commission has been charged with determining what went wrong. It is interesting to note that it is to report its findings at the end of 2010. Why take so long? When the big picture is viewed and the statistics examined, much is revealed. The findings are already clear and it is actually not difficult to determine what went wrong. The U.S. was a progenitor of an untenable financial system that supported an unsustainable globalization model, but it was not alone in carrying out the process. Great Britain was a fairly large contributor, and the system required the consent and participation of not only the developed nations but China, India and the emerging economies as well. In the frenzy and excitement of globalization, these leveraged-debts and consequent new-money were spread across the world. While the U.S. was not alone in the inflated process of globalization, it was a major participant and its financial institutions were largely responsible for inventing many of the concepts for the debt-leveraged securities that stretched across the globe. Therefore, examining the American experience reveals the reasons behind the creation of this untenable financial system.

After the second world-war, the peacetime real per-capita income in America was growing at an annual average of 2.7% until 1973, when real growth began to slow. From 1973 onward, the real per-capita growth rate averaged 1.8%. However, the biggest change was in the distribution of income. Earlier, from 1947 to 1973, the purchasing power of 95% of the people grew at the same rate as real per-capita income, but afterward only the top 5% of people saw their real income grow and it grew faster than overall per-capita income. In other words, the top 5% were receiving 2.2% while the other 95% were only getting 0.6% (Jencks 2008). That is a sizable difference in distribution of wealth, and this process continued for the subsequent three decades and escalated in the 21<sup>st</sup> Century. This is the reason that debt in the form of personal-credit was energetically marketed to



Americans as something positive. The majority could not afford to buy more without borrowing because the real wages were not increasing.

Globalization appeared as a corporate business model for increasing profitability, laying-off U.S. workers and transferring manufacturing to low-income nations, allowed the profits of companies to increase faster. The business model was temporarily beneficial and rewarding to the individual businesses, but the majority of American consumers could not maintain their purchasing power without going into further debt. Businesses would not have been profitable unless the debt kept increasing. Fractional banking only earns income when debt is constantly increasing. That is why even more debt and financial credit was marketed to Americans in the form of more credit cards, larger car loans, as well as larger and longer mortgages. Simultaneously, taxes were lowered, mostly on the already very wealthy; this also did not help the disposable income of the majority of consumers.

This is an untenable model for any economy and subsequently unsustainable for individual businesses as well. Overall, the United States as a whole had lived beyond its means because it did not produce for export enough valuable products to compensate for its purchases. It was untenable as a business model because it slowly but steadily reduced the average consumers ability to purchase the ever growing supply of foreign made products. Thirty percent of S&P 500 profits in 2008 were from financial firms. U.S. consumers were spending \$800 billion more than they earned.

The concepts celebrated as supply-side economics are misleading. In reality, business management reacts to the desires and ability of consumers. Growth is only sustainable when labor is paid enough to clear the market and has the ability to demand the product. The fundamental macroeconomic equations, identified earlier as 1 and 2 in this article, illustrate the fundamental problem is essentially a fallacy of composition. In the aggregate, the citizenry of national workers must be paid an amount to clear the markets and they must also save a portion of earnings for the future. The saving becomes a percentage of capital advanced for the future of the nation, which is used for new productive capability and the guarantee for service of accumulated debts. Otherwise, globalization will mean that one country wins and another loses. No amount of financial chicanery or glorification of globalization can circumvent this reality.

## **OBFUSCATION OF A SIMPLE PROBLEM**

In the simplest form, the problem has been one of a fallacy of composition, magnitude and sustainability. For example, China was able to become the industrial center for many productive activities precisely because it possessed the largest pool of labor and was easily able to adopt all modern technological methods. These methods of production were largely conceived in the West but they were also freely available to the East. The history of the development of most of these productive systems was costly, long and complex but there was no proprietary ownership and therefore no recompense. On the other hand, adopting the methods of production and coupling with a huge labor supply provides a productive advantage that does not exist in the West. Therefore, the magnitude of potentially profitable production in the East is far greater than the magnitude of profitability in the West. A continuation of the business model where the West primarily consumes what the East produces by paying for the product with debt-based money is patently unsustainable. This debt-money is nothing more than a promise to pay from a very uncertain future.

When imports are greater than exports it is a financial drain on a nation's economy. The United States is the largest economy and its money is the reserve currency of the world. The nation can sustain large imbalances for years, but it cannot sustain such imbalances forever. Shortly after the recent financial crisis began, the shrinking of trade was feared by both West and East, yet some level of shrinkage should not be feared. The reported economic growth over the past ten years has not been entirely real. A significant portion of the growth has really been global inflation. That is why commercial real estate prices, homes and corporate valuations rose astoundingly across the globe, almost everywhere. This portion of the newfound prosperity is an illusion and if it were permitted to continue would only serve to cause further cycles with downturns of even greater scale. These recessionary events can impose serious costs and harm many people as their perceived savings and equity evaporate. Because the price-inflation is usually a gradual progression it initially results in new employment but eventually the naked truth of inflation becomes evident. At some point, there is an inadequate real growth in overall consumer markets, no matter how much debt is created, and then the process comes to a halt and deep global recession ensues. Moreover, one cannot continue to transfer real capital outside a nation's economy without ultimately reducing payments to the factors of production within the country of extraction, and thereby reducing consumption and real

savings at home. This is the result when so-called “globalization and free trade” is promoted and dependant on pumping new-money endlessly. Some have referred to this process of illusionary increases in global growth as being Keynesian, but in this particular situation it seems likely that John Keynes may not have recommended such foolishness. He was a scholar of monetary systems and currency. Unfortunately, his precise thoughts and subtleties may have been overlooked by his successors (Keynes 1936). The United States followed Keynes recommended fiscal stimulus during the depression of the 1930s but at that time the government was not greatly indebted nor running trade deficits.

The highly leveraged debt threatens a collapse of the world financial system based upon fractional banking. Thus far, the only prescription has been to halt the unraveling by having the Western governments provide guarantees through the creation of more public debt. This is an interesting policy but not economically sound and certainly not a permanent solution. It only transfers the un-payable private debt into public debt. The debt remains a claim on income streams that were improperly projected and attributed to physical assets that often do not exist, and most probably will not exist in the future. That is why much of the past economic growth has been an illusion.

### **PALLIATIVE PRESCRIPTIONS ARE NOT SOLUTIONS**

A single currency simplifies trade transactions and real price-discovery is important to trade. Several nations have called for the adoption of the IMF’s SDR to replace the dollar as the world reserve currency. However, this would be of little consequence because the idea lacks a means of adjudicating the conflicting national objectives, particularly over time. Only if the SDRs were based not on a collective of currencies but tied to a physical commodity that represented average growth of global productivity would it solve the problem. It appears very unlikely that this would be part of a global agreement. There are insurmountable problems associated with attempts to integrate separate economies into one regional financial system, let alone to do so worldwide. On balance, there is no significant long-term economic benefit from fiat-currency unification. Any significant gains of productivity come from other reasons for greater economic activity and not because of unification. Real growth, in fact, arises from the non-currency policy changes not the denomination of currency. Such changes as immigration policies that promote the flow of laborers across national borders might induce growth. However, experience illustrates that many of the changes that take place from removing barriers for migration

have also caused serious social and subsidiary economic problems within the developed countries.

It does not matter how many different currencies exist, what matters are that the monetary units of measures should be translated and aligned with a standard that limits undesirable growth in money supplies. Previous to 1972, the gold standard performed as a basis for valuing one currency into another, and it greatly restricted undesirable growth in the supply of money (Solomon 1982). As long as there is no limiting commodity basis for a single standard behind a currency, it does not matter whether we have three, two or a single currency.

There are those that believe that the U.S. involvement in the Vietnam War was a necessary and important military adventure despite the loss of over 50,000 American lives and countless waste of resources. Likewise, there are those that believe that the more recent U.S. War in Iraq has been a necessary and beneficial use of America's resources. Those who believe this also tend to think that the push toward globalization and leveraged debt are glorious examples enlightened policies. The people who support these beliefs support one of two economic philosophies: that unregulated markets are necessary for capitalism to be successful or they believe that programs of bailouts and government spending are solutions to our national economic problems. However, neither is the answer. These policies are not solutions but only palliative prescriptions at best, aimed at temporarily suppressing symptoms, but they solve none of the underlying infirmity within the system. They are bad medicine based on ideologies and not unbiased analysis. Instead, the United States and other economies need to be rededicated and restructured not re-inflated.

## **CONCLUSION AND RECOMMENDATIONS**

Trade can grow and should be encouraged, but not by mechanisms that distort the underlying realities. Increases in money supplies above the rate of actual productivity, whether by central banks or other financial institutions, can only serve to promote a dangerous illusion that eventually leads to painful readjustments. In the past, the so-called gold standard was a valuable mechanism, essentially a modality that prevented undue leveraging of monetary expansion (Solomon 1982). Something similar is needed to prevent inordinate expansion of money supplies beyond the rate of increase in actual physical productivity.

International trade will depend on intelligent innovation in accommodating the factor differences between countries and regions of the world. We look forward to a time when national policies recognize that mercantilist practices are not beneficial in the long run because they do not advance the mutual interests of trading partners. Indeed, policies must incorporate the understanding that trade is a practice between partners and it needs to foster economic balance for all the participants. There can be no shortcut through exotic financial instruments and deceptive accounting. Ideologies offering pleasant sounding arguments to the contrary are meaningless because they are not completely logical when subjected to authentic economic analysis. It is wise to avoid such futility, and instead rely on the imperatives of sound and comprehensive economic analysis.

Post-mortems of the financial crisis will continued to be written and read for many years but it is unlikely they will add substantially to the analysis. What is needed now is to quickly face up to the real problem, which is the unsustainable global business of large trade imbalances, inordinate amplification of money supplies by debt instruments, wage suppression and growing income inequalities in developed nations. This has been the process that eventually causes painful readjustment and destroys national wealth in the developed economies in order to benefit a few “global citizens.” What is desirable now is to find solutions for better business that allows real growth for both East and West. Businesses and the banks need something other than re-inflation. They need more than survival, they definitely need to seek out the strategies for improving their efficiency and increasing core values. Regulatory agencies must establish firm policies to significantly restrain leveraged financial products of investment firms. In the United States, the full extent of banking limitations of the 1933 Banking Act and the regulations of Glass-Steagall need to be restored under law. Simultaneously, the 1999 Financial Services Modernization Act and the Commodity Futures Modernization Act that deregulated derivatives trading definitely need to be repealed because they are the foundation of the financial debacle.

Commercial enterprise and investors should focus on the opportunities in target markets where consumers are truly benefited and where investors can receive a real return and not rely on mythical profits. Simultaneously, the governments need to balance their books rather than rely on the subterfuge of inflation to hide the real magnitude of taxes. The world also needs intelligent innovation in accommodating the factor differences between countries and regions of the world.

For some of the developed nations, traditional fiscal stimuli in the form of tax cuts have reached practical limits. Certainly, this is true for the United States where annual national deficits, public and private, are running at extremely high levels. However, taxes could at least effectively limit inefficient income-distribution by reinstating a top tax rate that essentially is never paid. The highest rate used to be over 90% plus additional state taxes for incomes over \$4 million. Effectively a 100% marginal tax rate after some designated amount. Such a high tax rate is never actually paid but it operates to prevent large extractions of capital from successful corporations by individuals, and instead the companies use this capital for real growth and dividends rather than distribute it to top executives. It is essentially a 100% inducement to growth. It is never actually paid as a tax, but it does induce job creation. This is precisely what transpired from 1948 through 1980. Moreover, this type of tax policy costs nothing.

The government stimulus spending cannot correct a structural problem caused by private monetary amplification, unreasonable debt and outsourcing. The major developed nations cannot afford to continue flooding the world with debt financing based on an unlikely economic future. This is true for Europe and America as well. For example, it appears that the United States needs to reestablish some sort of strong domestic manufacturing base, if real economic growth is to begin again.

There is a very high cost to transferring real domestic capital into other countries. Outsourcing and extracting capital removes the opportunity for domestic production and unavoidably decreases economic opportunity at home, thereby decreasing the real incomes of most households. This is easily seen from the macroeconomic analysis identified in this article. Damaging one country's ability for the purpose of enhancing another country is not a wise policy precisely because it is destructive and ultimately unsustainable. As a nation, America has within its borders adequate resources for reviving real economic growth. The choice of new industries is open, and these need not be the old industrial technology, instead they can be the future of technological innovations such as alternative energy and new discoveries of bioscience. There is already a heavy debt owed to foreign entities, and America cannot continue exchanging its dollar-promises for unlimited foreign product and resources. It must renew domestic production as a backing of its currency, not leverage debts. For these purposes, tax policies can be employed, 1) make wage increases attractive by treating the cost of domestic wage increases with enhanced deductibility from corporate income tax and 2) treat alternative cost-savings from

outsourcing as taxable income. This is carrot and stick policy that encourages renewed domestic development and growth without explicitly restricting imports.

Real growth in the United States and other developed nations could begin again. It is possible, but the United States will need to manufacture more innovative products that can easily be sold domestically as well as traded internationally, and thereby begin paying its foreign debts with real production. The new industries, producing within the national borders, will need to have sustainable competitive advantages to succeed in the global market. The world needs the United States to be rededicated and restructured not re-inflated. American can again become the powerhouse of productivity, not a purveyor of financial magic tricks.

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