Down Wave Act II

Tsang Shu-ki (www.sktsang.com)
6 May 2010

The doom returning?

Although I had predicted severe down wave for the global capitalist system for quite some time (http://www.sktsang.com/ArchiveIII/Delayed_calls.pdf), the financial tsunami of 2008-2009 was met with unprecedented monetary and fiscal responses by authorities and governments, outside my anticipation. History is interactive to a certain extent, and disasters could either be swallowed (with very unpalatable consequences) or be postponed, for a while but with worse to come.

I confessed last year that I did not know what the short-term eventuality would be (http://www.sktsang.com/ArchiveIII/Tsang-CPU-DRC-090928.ppt).

After a relatively less pressing period, when the most bearish of bears had to hide in the closet (and I lost a dinner for that matter), it seems that Down Wave Act II is emerging, in the form of sovereign debt crisis in smaller European economies (PIIGS) of the euro-zone.

Interactive history

In general, the unfolding drama is a vindication of my long-run view. However, the present gloomy market commentaries by many, including a collapse of the euro, fail to learn the precise lessons of the last twelve months.

If some banks and corporations were "too big to fail", would a government be "small enough to fail"? The euro was a political construction. Most economists who are informed about "optimal currency area" literature know that the euro-zone has never been "optimal" in the proper sense, especially when so many countries previously under Russian control rushed into the EU after the former Soviet Union disappeared.

So easy to create and destroy currencies

For those who doubt that countries might be kicked out of a "monetary union", or could opt out to create their own currencies, and then survive, just study the experience of East Europe, especially the Baltic countries (Estonia, Latvia and

Lithuania). Further references on Bosnia, Bulgaria (and Argentina) etc. are available, including on my website (http://www.sktsang.com/seminar.html).

My point is simple. The global economic system is entering phase II in its down wave. Monetary and fiscal loosening unheard of has been employed to delay the call. Europe, under the ECB, did much less in the monetary sphere, whereas the US Fed (chaired by Greenspan and Bernanke) could print as much money as deemed necessary.

It should therefore not be surprising that fiscal crisis would surface first in Europe for economies without access to the printing press, then in the US after a lag when its growing fiscal disequilibrium could no longer be hidden.

Since the developed economies have not effectively addressed the fundamental imbalances which generated the global crisis in the first place despite the tsunami (http://www.sktsang.com/RF/Tsang_0909.pdf), it is only a matter of grid positions (to h….).

Anyhow, euro-zone without some of the weaklings is a possibility; but the demise of the euro as an institution would involve biblical imagination even for a pessimist like me. What would be the global economic system then? Would the US dollar still dominate, assisted by a convertible Renminbi? Would the German mark and French franc re-emerge? Should gold take over? What would happen to the international financial architecture?

Hard time ahead

My intention is not to defend the euro-zone as a political artifact, except in the sense that a more even global economic system has been long overdue. At the end of the day, though, international economics has seldom been decided by rationality.

Act II of the worldwide down wave might turn out to be more difficult to contain, now that the weapons in the hands of the authorities are in short supply. There are still some, including monetization by the ECB. But even as procrastination measures, they are approaching points of diminishing (if not negative) returns.

I hesitate to say it: but the future would largely be determined by politics, not economics. Historical mean reversion? I don’t know.