

## History unfolding - economic crisis in an uneven world

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### *Rationality not emotion*

I have been bad-mouthing the US economy for quite some time. In the process, I've managed to generate some decent returns by putting money where my mouth is.<sup>1</sup> Yet emotion and rationality shouldn't be mixed up. I don't like the hegemonic foreign policies of the Bush Administration, but this has nothing to do with my analysis of the problems in the US economy, which predate George W. Bush, Bill Clinton, the old Bush, and even Alan Greenspan..... The US was (and probably still is) one of the most enjoyable places on earth to take a vacation. Its people are unpretentious, friendly and in comparison make most French look like snobs. Again this shouldn't affect the accuracy of what I'm going to say here.

### *The folly and the rescue*

Not surprisingly, the inflationists and the deflationists are fighting it out in the public arena. Following the bursting of the biggest financial bubble of all times, the US Fed led by Greenspan resorted to the greatest loosening one could possibly imagine and Bush quickly turned Clinton's fiscal surpluses into the largest deficits in US history. Meanwhile, the world continued to subscribe to greenback debt issues as US trade imbalances entered uncharted territories.

What result did you expect? That such massive rescue efforts would fail, even in the short run? Then you must be a diehard Marxist or genetic anti-American. What follows would hardly interest you.

My own analysis is that these gargantuan operations have succeeded in averting a possible follow-up disaster to the stock market meltdown. Obviously, Greenspan and his generals have read the history books very carefully, and the literal "helicopter" with loads of currency notes has been on the alert. The world is alarmed by US economic recklessness, but has limited choice in dealing with it. Conservative economists including the Austrian School are sickened by the shameless government manipulation of a free market economy to avoid the necessary though painful downward rectification

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<sup>1</sup> Needless to say, my writings---including this short piece---do not provide any investment advice.

of past misallocation of investments, while radicals are predicting that the doomsday would come very, very soon.

I, for one, think that it could be months, perhaps years, before the “reckoning”, which, in any case, would not be “final”.

### *Debt-deflation and resource-inflation*

If someone pointed a gun at me and forced me to take side in the debate, I would say I’m a “deflationist”. With more time to explain, I would roll out my arguments at different analytical levels:

- I am a deflationist for the short run, meaning up to 3-5 years. That does not preclude the possibility of increased inflationary pressure in the run-up to the necessary adjustment process, particularly given the “hold-no-bar” rescue efforts.
- ***I am a debt-deflationist***, rather than a deflationist with simple-minded regard to the CPI. The deflation I expect is highly correlated with the destruction of portions of the massive internal and external debts built up in the US economy. Adjustment of asset prices and financial evaporation would be a much more serious problem compared with retail deflation in a downward spiral which was theorised by economists like Irving Fisher and Hyman Minsky.<sup>2</sup>
- I am a debt-deflationist with a long view, not just from a cyclical standpoint. In other words, the present accumulation in US debt has not been the result of just one or two business-cycle upswings. It has been a structural pattern over decades and I think there is lot that we should take from the theories and empirical writings on long waves.<sup>3</sup>
- I am a debt-deflationist who analyses with a global framework. Unlike in the last Great Depression (1930s), the US is now the uncontested superpower in the world. Operating under a system of fiat money without the constraint of convertibility, the US Fed is free to issue as much reserves as it likes, subject to its own cyclical observations and policy understandings. Unfortunately it unabashedly serves only US national interests and has a rather limited political horizon. In any case, many in

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<sup>2</sup> See for example Hyman Minsky, *Can “It” Happen Again? Essays on Instability and Finance*, M.E. Sharpe, 1982. A focus of my M.A.(Econ) dissertation at the University of Manchester was on Minsky’s “Post Keynesian theory of money”.

<sup>3</sup> Read my “Long Waves: An Update” ([www.sktsang.com/ArchiveIII/Long-WavesUpdate.pdf](http://www.sktsang.com/ArchiveIII/Long-WavesUpdate.pdf)).

the world, including Japan, China, and other developing economies, depend on its huge markets for export-led growth. And the “symbiosis” whereby these counter-parties reinvest their current account surpluses in US treasuries is part of the queer historical game. So the US problem becomes the world’s problems. Most countries on the other side of the table are wary of a sudden collapse of the symbiosis in lieu of a viable alternative, no matter how much joy (concealed or otherwise) that some of their citizens and indeed politicians might harbour in seeing the US in distress.

- I am a debt-deflationist with a historical perspective. Other centres of powers are rising and a multi-polar world is inevitable in the long run. Mind you, the US is not going to disappear. It would remain a superpower---indeed, the comfortably leading, if psychologically hurt, number one---irrespective of how it goes through the approaching downward economic adjustment. And with China and India reaching even middle-level development on average, you do not need to be a firm believer in the “peak oil” hypothesis<sup>4</sup> to realise that the world would face increasingly severe growth constraints in terms of resources, short-run fluctuations notwithstanding. Either the US has to change its spendthrift habits dramatically or the new powers turn out to be incredibly efficient. Since both are unlikely come what may, a fight for resources is in my view equally, if not more, probable than a clash of civilizations in the 21<sup>st</sup> Century. We already have had a foretaste of that in the surge of energy and commodity prices over the past few years, which as a post-bubble phenomenon is amazing. ***Hence I am a resource-inflationist!***

### *Defying easy categorisation*

The above complex analysis defies easy categorisation. The status quo is not sustainable in the long run. But there is still a great deal of vested interests to maintain it, if only because the default is ominous and coordination for an alternative is so much more difficult.

The status quo is neither inflation nor deflation in the conventional sense, especially if one only looks at the CPI. US retail inflation is contained by globalisation of production and supply despite upstream and midstream pressures in raw materials and energy. The developing economies, especially China and others through China via outward processing, hold yet significant cost advantages over the US. Hence they are able to

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<sup>4</sup> See the documentation and analysis posted on the website of the Association for the Study of Peak Oil and Gas (ASPO) ([www.peakoil.net/](http://www.peakoil.net/)).

bear the climb in resource prices and charge US importers cheaply as their goods flood downstream through Wal-Mart and the likes. In technical jargons, the expansion effect exceeds the margin squeeze. The recycling of dollar reserves, on the other hand, helps to depress US interest rates, excites the housing market, and supports the stock market, all the while keeping consumers happy and buying.

The symbiosis is very beneficial up to a point; but the exit strategy is beset with moral hazard. The Chinese want to diversify out of their US dollar reserves while hoping that others would not do so. Japan thinks likewise. So do South Korea, India, Russia and .....

The US authorities are not stupid. They know the unprecedented problems that the country is facing. But Greenspan is on the way out; Bush is in his second term; and the neo-cons already have their eyes on the future “war on resources”. Those officials with a more recurrent responsibility for the US economy may ironically agree with Alex Wallenwein in that only a strong country can have a weak currency.<sup>5</sup> Their calculation must be that the other countries so reliant on the US market and financial system simply dare not dump the single superpower in the world.<sup>6</sup> Hence with an “engineered decline” in the value of the greenback, the status quo can drag on, until their terms expire or when they can find more lucrative jobs in the private sector.

This is a powerful viewpoint. Therefore I confessed at the outset that months, perhaps years, could elapse before the “reckoning”.

### *Reckoning in an uneven world*

When it arrives, any reckoning will involve debt deflation in the US---I don't see how that could be avoided given the root causes of the cumulative problems. It may be touched off by a major economic or political event, or collective hysteria similar to a fire in a packed theatre. US CPI should fall, and energy and commodity prices should head south; but stagflation, at least during some stages in the downwave,<sup>7</sup> is also

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<sup>5</sup> Alex Wallenwein, “Only The Strong Could Have Weak Currencies”, posted as [www.financialsense.com/editorials/wallenwein/2005/0419.html](http://www.financialsense.com/editorials/wallenwein/2005/0419.html).

<sup>6</sup> See the more “optimistic” arguments of Keith W. Rabin and Scott B. MacDonald in their article “Do Security Concerns Influence Asian Central Banking Holdings?” ([www.kwrintl.com/library/2005/srasianbanks.html](http://www.kwrintl.com/library/2005/srasianbanks.html)).

<sup>7</sup> For example, a sharp fall in the US dollar pushes up the import bill and widens the trade deficit as demand for foreign goods remains inelastic, even though external withdrawal of funds leads to a surge in US interest rates and the economy goes into a recession. J curve effect is the benign term to use if a vicious circle of the Latin American type could be avoided. Stagflation

possible.<sup>8</sup> Precious metals are a different story if a plunge in the greenback is widely understood to be a failure of an anchor-less international finance system.

In general terms, my forecast of what lies ahead is captured in the phrase “delayed calls”, as I explained in another piece a year ago.<sup>9</sup>

The difficulties about predicting energy and commodity prices hinge on the uneven global and historical developments I discussed above and the increasingly heralded “fight for resources”. Will the downwave be a predominantly US affair? If so, other countries might use the chance to stock up resources and the fall would be limited. Or will China, Europe, India, Russia, and South Korea be caught in it? And how deeply? In a worldwide recession or even depression that persists beyond a short period, a bear market for oil and commodities is almost a certainty.

### *Staying out of the fray?*

An interesting historical note is that during the last Great Depression, both China and the Soviet Union were not severely affected. One of the reasons that China wasn't is attributed by economists to the silver standard,<sup>10</sup> but one could argue that its closed economy was bad enough anyway. The former Soviet Union was, on the other hand, both closed and “communist”.

Now China and Russia are of course more open and exposed to spillover effects of an economic downwave in the US, but not to the extent of many other smaller-size economies. Elsewhere I have warned China against pinning too much hope on an outward-oriented development strategy in an unstable world economy.<sup>11</sup> Promoting its domestic markets and nurturing its internal economy must be given more emphasis.

Are top Chinese officials wise enough to have taken precautionary measures against economic and financial tsunamis that originate from outside? Who knows?

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would then give way to outright downward adjustments in both the real and the nominal sectors.

<sup>8</sup> It may be argued that a “mild” form of stagflation is already observable in the US. See Paul Krugman, “A Whiff of Stagflation”, New York Times, 18 April 2005.

<sup>9</sup> “Delayed calls: the paradox of demand side deflation versus supply side inflation” ([http://www.sktsang.com/ArchiveIII/Delayed\\_calls.pdf](http://www.sktsang.com/ArchiveIII/Delayed_calls.pdf)).

<sup>10</sup> For a recent treatise, read Cheng-chung Lai and Joshua-Shiang Gau Jr., “The Chinese silver standard economy and the 1929 Great Depression” *Australian Economic History Review*, Vol. 43, No. 2, July 2003, pp. 155-168.

<sup>11</sup> “泛珠三角經濟整合：機遇還是挑戰？” (“Pan-PRD Economic Integration: Opportunities or Challenges?” in Chinese) ([http://www.sktsang.com/ArchiveIII/Pan\\_PRD.html](http://www.sktsang.com/ArchiveIII/Pan_PRD.html)).