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# FROM THE FOUNDER

# Welcome to the Late Nineteenth Century

*The glass-is-half-empty view of today's economy.*

The economy's animal spirits are tough to predict. The glass could be half full, but it could just as easily be half empty.

The world, after all, is returning to the late nineteenth century. In today's new Wild West of disorder and unpredictability, there is no Sheriff Wyatt Earp on the scene. Case in point: Russia annexes Crimea. The potential for Putin copycatting worldwide is enormous.

This is the beginning of a new economic world, as well. The U.S. Congressional Budget Office and the OECD both predict slow global growth ahead. The geopolitical landscape will increasingly be one of volatility, anger, risk, and violence. That is what happens in a world desperate for growth.

There could also be greater financial risk. History prior to World War II shows that financial crises occurred roughly every ten years. They were a fact of life. The relatively stable financial system of the post-war era was the anomaly. Probably not any more.

One would think that with all of mankind's advancements, we'd be better able to resolve financial tensions before they become major calamities. We can't. Maybe it is because our brains are genetically hardwired for the short term. But looking at the global financial system today, there are considerable risks that could easily prove calamitous.

China's shadow financial institutions, for example, are at risk of becoming the next Fannie Mae. In 2013 alone, this mysterious collection of unregulated trust companies, insurance firms, off-balance-sheet lenders, and, yes, pawnbrokers grew by a size equivalent to the entire U.S. financial system, estimates analyst Philippa Malmgren (p. 75). They are an accident waiting to happen.

Throughout the first decade of this century, China, financed in part by this system, invested in new urban industrial space and housing equivalent to an incredible 322 Manhattans. Talk about potential investment bubbles.

*It is a world with a collection of pygmy leaders who assemble from time to time. They call themselves the "G20."*

**The Mighty G20: Poised to Take on Global Challenges.** *At the recent G20 meeting in St. Petersburg in September 2013, leaders pose for the traditional "family" photo.*

The problem is that both the corporate sector and local governments there have cash flows too small to service the debt created by such investment. Producer prices are declining by 2 percent, while wages are increasing by 10 to 12 percent. Translation: Chinese producers are losing money. Empty apartment buildings produce no returns. Neither does infrastructure spending. Now the shadow banks are up to their eyeballs rolling over loans at maturity and replacing them with new riskier loans.

To make matters worse, China faces a competitiveness nightmare. Wage demands in Mexico today make labor there 20 percent cheaper than in China, according to Malmgren.

The eurozone's situation is hardly reassuring. European Central Bank President Mario Draghi has, through the clever use of verbiage, stabilized eurozone interest rates. What he hasn't been able to do is stabilize eurozone politics. A rising tide of populist politics threatens to upend the entire euro experiment in coming years.

And don't forget that European bank balance sheets are still loaded with unsustainable debt. The toxic link between Europe's massive sovereign debt and its compromised bank balance sheets has proved economically deadly: mediocre growth rates, soaring youth unemployment, and the risk of deflation. These are all symptoms that will worsen the longer the euro remains overvalued.

And why is the euro so strong? One reason is that since June 2012, the European Central Bank's balance sheet has shrunk by a quarter while the Federal Reserve's has increased by a third, as Stephen Cecchetti, formerly of the Bank for International Settlements, argues (p. 4). Another is the result of the economic matrix of recent events. First, the European Central Bank promised the world to "do whatever it takes" to stabilize and preserve the euro. Then, around the same time, the Federal Reserve's tapering of its quantitative easing crunched investment in the emerging market economies. The result: a lot of investors in emerging markets exited for Europe. This move helped produce a euro strengthening that now risks a serious bout of deflation. Deflation is devastating for economies in heavy debt, which includes a lot of the eurozone.

Meanwhile, U.S. policymakers give lip service to America's own debt problem. In an economy with so much slack, they say, debt doesn't matter. Yet as Harvard's Richard Cooper has wisely warned, "If interest rates were to return to 2007 levels, interest payments on government debt could rise by 20 percent. … The United States and the eurozone are particularly vulnerable in the short term, because the average maturity of sovereign debt [is so short]." Debt servicing could eventually consume large chunks of the federal budget.

*Chinese shadow financial institutions are at risk of becoming the next Fannie Mae.*

Recently Warren Buffett proclaimed: "The best is yet to come. … The mother lode of opportunity resides in America." U.S. stock investors went wild. What they failed to read was the second half of Buffett's statement. Federal entitlement and state pension promises, he said, can never be met under today's unrealistically rosy scenarios. We "under-appreciate [this] gigantic financial tapeworm."

We also under-appreciate the dangers of today's brave new world. It is a world with a collection of pygmy leaders who meet from time to time. They call themselves the "G20." A confident crowd, they talk, give lip service to some vague platitudes, then fly home despite the chaos and uncertainty all around them. After all, it's the late nineteenth century.

—David M. Smick
*Founder and editor,* TIE, *and author of* The World Is Curved: Hidden Dangers to the Global Economy