The New Deal v. 3.0: Tire Wars » « Credit Is Shrinking

Economic Megatrends That Will Drive Our Future

By Jeff Harding, on September 15th, 2009

By Jeff Harding.

We are plunged deep into the biggest credit-business cycle in world history. Many cycles have been worldwide, but this one dwarfs all others, including the Great Depression. An ocean of money and credit flooded every corner of the globe. The culture of easy wealth worked its way into the smallest economies from Norway to Chile, from Iceland to Mongolia. Economies built on commodities exports, even energy exporters, have felt its impact. The inevitable bust sent the world into economic decline wiping out trillions of dollars of wealth. Built largely on credit, the resulting debt is now being liquidated causing worldwide deflation.

Business and credit cycles are always created by central banks and this one is no different. While we can blame the greed of Wall Street and London's City, capitalists are just players on a stage where greed always exists. It takes something more than greed to create massive cycles like these, and that something is the creation of money and credit out of thin air, something only central banks and governments can do.

> *The question we face now is: how has the playing field for our economy changed and how will those changes affect our future? The answer to these questions will determine the future of the world's economies.*

The economic world has changed. There are new trends, megatrends if you will, now at work in our economy. They are "mega" trends because they overarch and impact everything else in the economy and will do so for quite a while. There are other major trends at work as well, but they have been operating as a part of the basic framework of our economy for decades. These megatrends have emerged from the credit cycle because people change their behaviors in response to a crisis, and it would be foolish to assume that everything will just go back to the way things were before.

These aren't predictions of the future, because circumstances change. No economist can accurately predict the future, at least in the detail many economists claim they can do. There is just too much data from the millions of decisions that our fellow citizens make every day to know enough to predict with any accuracy. How many economists predicted this crisis? Very, very few. Think of these megatrends more as chalk marks on the playing field that will guide human economic behavior for some years.

Megatrend No.1. *The culture of consumption is broken and won't return to former levels. This is the key to everything.*

For the last 30 years our economy has been based on personal consumption. From 1980 to 2007, personal consumption went from 54.4% of GDP to 77.3%. We went on a spending spree financed by borrowing, reduced savings, and asset inflation. Most obvious was the rapid rise in home prices. We came to think of our homes as an ATM, and kept pushing those buttons. We felt rich: our homes appreciated, our 401(k)s appreciated, and, who needs savings?

From the high of 2007 our net worth has plunged 20% (nominal), from $62.591 trillion to $50.377 trillion as of Q1 2009. Down $12 trillion, or about equal to one year's GDP. That has dire implications for consumer spending. During the boom, debt as a percentage of spendable income went from 68% in 1980 to 138% in 2007. We are now in the process of paying it back. And, since our main assets, homes and stocks, have declined, the bank wants its money back.

There is nothing like fear and an uncertain future to prompt people to save. As the savings rate has increased, consumer credit continues to decline, wages are decreasing, and unemployment is rising. It will take consumers a long time to reduce their debt. If incomes don't grow from current levels, it will take a savings rate of 5% to achieve a 5% annual reduction in the household debt-to-income ratio, according to a McKinsey Global Institute study. At this rate it would take about 7 years for this ratio to return to levels seen in 2000 (101% then, vs.138% today). If incomes grow by 2%, then it would take a savings rate of 2.3% to achieve a 5% reduction in the ratio. *Every percentage point of savings reduces consumption by about $100 billion per year.*

This doesn't mean people won't spend; it means they will spend less and save more. In an economy of which 70+% is based on consumption, this represents massive change. It means that GDP will remain subdued while consumers rebuild their balance sheets. The positive note here is that savings reduces interest rates, which attracts business borrowers and allows them to expand production. This allows industrial spending to spread throughout the economy and brings about an economic revival.

The one caveat? Inflation would tend to result in quicker debt paydowns as old debt would be cheaper to pay off with inflated dollars. Inflation would cause people to buy things as they dump depreciating dollars for appreciating goods. But inflation has its own problems.

Megatrend No. 2. *Consumers will continue to increase savings to prepare for retirement.*

Boomers are facing retirement and they aren't ready. In fact, about two-thirds of Boomers are unprepared according to another McKinsey report. The definition of "prepared" is having enough income to cover about 80% of pre-retirement spending. This is significant because Boomers are 70 million strong, the largest population group in the U.S.

Since they entered the economy in the 1960s, Boomers have driven GDP to new heights, have had the highest incomes, and have accumulated the most assets. But the one thing they haven't done is still save enough for retirement. This has two important impacts. (1) They will work longer to (2) accumulate savings in order to retire. While their continued participation in the economy will be a positive, the fact that they will restrict spending in order to save is a negative for an economy based on consumption.

Also, as Boomers retire over the next five to seven years, even assuming they continue to work a couple more years, a large percentage, up to 40%, will still not have sufficient savings for retirement. This has two negative impacts to the economy and consumer spending. First, by reducing their participation in the economy, GDP will go down. It's obvious that the more people in the workforce, the greater economic activity there will be. Second, this large group won't be spending as much during retirement.

There is one dirty little secret at the heart of most Baby Boomers: their think their parents are going to leave them a lot of money. Perhaps. But only a small percentage of Americans ever receive an inheritance. According to one study, only about 7 percent of the population will ever inherit money – typically less than $25,000. Mom and Dad are living longer and medical and nursing home costs are eating up their assets. Only 1.6 percent of Boomers will inherit more than $100,000, and they tend to already be successful in their own right.

Don't expect spending levels to stay at 70% of GDP. I don't know what it will be, but if I were to guess, I would say it would fall off to about 66% to 67%. We'll all have to adjust to this new reality. It doesn't automatically lead to negative growth in the long-term, but in the short-term it represents an economic readjustment that will take the economy time to adjust. This adjustment process is called a recession where enterprises which were profitable on because of the Fed's monetary expansion are now rendered unprofitable. It is difficult at present to foresee how long this process will take. This is because we have seen the greatest expansion of credit ever, and the extent of what is called "malinvestment" is difficult to judge. But the market will tell us. Another factor is that the government is doing everything they can to forestall this adjustment which leads to economic stagnation.

Megatrend No. 3. Declining U.S. consumer demand will continue to negatively impact the world economy.

The developing economies of the world live off of demand from developed nations. Most of them have not created enough wealth to generate sufficient internal demand for consumer goods to drive their economies. While their domestic sectors are increasing, they are still dependent on developed nations. If U.S. consumption continues to decline, the countries that ship goods to us will suffer unless they can find new markets, including domestic markets.

China's economy is based on exports and the U.S. is its biggest trade partner. For the tenth month in a row, exports have declined (23% YoY in August). China's recent economic gains are either fictitious or a temporary result of government fiscal stimulus. They are facing huge unemployment and dislocation of their workforce. Some estimates put China's unemployment levels at 24 million. China has engaged in massive Keynesian fiscal stimulus mostly aimed at public infrastructure. These expenditures are about 14% of their GDP ($575 billion) but, with falling exports, it is unlikely that they can sustain growth. It appears they are just creating another stock and property bubble.

We know that economic reports coming from China are mostly numbers manufactured by Beijing. I would assume that unemployment is higher. We take for granted that China will continue to grow and become a leader in driving the global economy, and I believe that will be so. But with 36% of their economy based on domestic consumption, they have a long way to go before they are world economic leaders. China needs us to lead it to prosperity, not the other way around.

Megatrend No. 4. *Deflation will continue for some time.*

Deflation occurs where there is a demand for cash because of economic or political uncertainty, or where the demand for money exceeds the existing money supply at any given moment. Both factors are operating right now. This is reflected in the economy by falling prices, such as with real estate. Also the money supply is contracting despite the efforts of the Fed. People are holding on to their cash. Keynes referred to this as "hoarding" a pejorative term that suggests that people are too stupid to handle their own affairs and that they should go out and spend to help stimulate demand. As we've shown before, deflation is the necessary healing process of any credit cycle boom and saving is a logical response to uncertainty.

There is a lot of talk about inflation, but you can't just look at the Consumer Price Index for guidance because it doesn't include housing as a price component. Housing prices and commercial real estate are the main asset classes now being deflated because of all the debt incurred to buy real estate or finance consumption. Wages and work hours are also decreasing, and we have all seen the decline in the prices of many consumer goods. Consumer credit continues to collapse as July marked six months of decline in a row, down 10% this year. Banks continue to tighten credit as well. Money supply, from M1 to MZM, is declining. This is an international trend playing itself out in just about every country. The Fed cannot stop declining asset prices.

It's not over. Real estate prices will continue to decline. The current devaluation of commercial real estate is just starting. Housing prices are still not in synch with supply and prices decline. I believe many more banks will go under during this phase of deflation. Credit card debt and student loans are another problem area and debt reduction and bankruptcies will continue to put downward pressure on prices.

Yes, at some point it is likely that credit will expand again, and then we'll see inflation. But banks will continue to hold on to their reserves until they see that they won't lose money making loans.

Megatrend No. 5. *Home ownership rates will decline to more historical levels of, say, around 66%, down from the high of 69% during the boom, which will keep a lid on home prices.*

Every time the housing market goes through a cycle, we are reminded by the housing industry that long term demographic trends favor the construction of millions of new homes. It would be foolish to argue the basic logic of this premise, but in the short term it never works that way. People do buy homes because of the build-your-nest syndrome. But they also make economic decisions based on the perceived risk versus reward of buying a home. Potential buyers have now learned a valuable lesson. While they were told home prices would never decline year-over-year, and that such declines hadn't occurred since the 1930s, they are painfully aware that it is happening now. This changes people's perception of the economic benefits of home ownership.

From 1970 to 1995 home ownership rates were about 64% to 65% of American families. Starting in 1995 they shot up reaching a high of more than 69% in 2004 and 2005. We know the reasons for that (cheap money and cheap credit), but I don't see that scenario repeating itself for some years. Also there is the fact that the number of buyers who were "investing" in homes was as high as 24% of all sales late in the cycle. This won't repeat itself either, barring a massive reinflation of the housing market.

While home prices are declining, I think buyers will continue to enter the market seeking bargains and eventually the market will find a bottom, but I believe the "home-as-an-investment" concept has been shaken off of its pillar and that this trend will reduce the rate of homeownership to more historic levels. This will dampen the market for home builders, reduce construction industry jobs, and squeeze profit margins for an industry that was once about 3% of GDP.

Megatrend No. 6. *Government stimulus and recovery programs only delay recovery and deepen the pain for workers.*

There has never been an example where Keynesian government spending created real growth in an economy, anywhere. We know that government spending through fiscal stimulus has only been about $100 billion so far, not sufficient by Keynesian standards to help a $12 trillion economy recover. So despite what the Obama Administration says, they can't claim stimulus is working. For example, Cash for Clunkers just "borrowed" against future sales and the effect will wear off. The end result of stimulus is massively increased national debt.

I have challenged Keynesians to point out an example where Keynesian stimulus has worked and I have not had a response nor have I seen any data that would support their premise. Japan is the classic example where most of the suggested Keynesian remedies were tried and failed miserably. The result was economic stagnation from 1990 to 2003. And, they are doing the same things again in this crisis. The result for Japan has been continuous, sluggish GDP growth – an average of only 0.6% a year since 1991.

What these stimulus programs do is confiscate money from some people and give it to others to spend on things the government deems worthwhile. You can see for yourself what these programs are by going to Recovery.gov., the government's web site itemizing expenditures under the American Recovery and Reinvestment Act. Much of it is just a waste of money. And, once the money runs out the so-called economic boost will end because the government doesn't create wealth, it just spends it.

We're now two years into this crisis and people are running out of unemployment benefits. Please compare the recession of 1920 and 1921 to the recession-turned-into-a-depression of 1929-1948. Harding and Coolidge basically did nothing and the economy recovered from a worse crash than 1929. Yet the meddlesome policies of Hoover and FDR turned an ordinary recession into a massive depression. Politicians never learn.

Megatrend No. 7. *Massive federal deficits will double the national debt, result in higher taxes, and will act as a permanent drag on the economy.*

The Administration just announced that the deficit over the next 10 years will be up another $2 trillion to $9.14 trillion which will push the true national debt to about $25 trillion by 2019. This is double the current national debt and it will have negative economic implications. Even if the debt is increasingly financed by U.S. savers, massive federal borrowing will put downward pressure on the dollar threatening its status as an international reserve currency, which in turn will drive up interest rates, and drive up the cost of capital for private borrowers ("crowding out"). This means that it will be more difficult to finance business which inhibits the creation of wealth and jobs.

The costs of Obamacare have been seriously underestimated. As I have pointed out, studies of national health care systems around the world reveal that they have always exceeded cost estimates and our system, whatever form it takes, will be no different. Newly disclosed documents reveal that the Johnson Administration knew that Medicare cost estimates given to the public were a lie, but LBJ was afraid it wouldn't get past Congress if the true costs were known. Medicare will probably not be reformed as a part of this bill, and it is seriously underfunded. Medicare alone will need vast injections of taxpayer dollars.

It is obvious where the money will come from to pay the debt. I doubt the debt will be entirely funded by monetization (printing dollars). It would worsen the problem and lead to high inflation and Obama's advisers know this. The money will come from new taxes on middle income and upper income taxpayers. It can't be paid by upper income taxpayers alone; there just aren't enough of them. Obama won't raise "middle class" taxes or he will break an obvious campaign promise. I believe that we will see a new, more politically acceptable, tax, a national sales tax like the European VAT (value added tax). On last Thursday's Town Hall meeting with Treasury secretary Tim Geithner, Geithner almost admitted that higher taxes were coming. I guarantee that they will.

When the a non-wealth creating entity like the federal government takes that much capital out of the economy, it will slow economic growth as interest rates rise and capital sources are diminished.

* * * * *

Where does all this lead?

All cycles eventually bottom out and growth resumes. The timing of any recovery is impossible to predict and for the most part it depends on what the government will do (or, hopefully, not do). The more the government interferes with the recovery process by propping up bankrupt banks, by manipulating the economy with fiscal and monetary stimulus, by creating a huge national debt, and by increasing taxes, the longer it will take.

With commercial real estate in serious decline, deflation will continue, and we'll see more bank failures. While we may see a "bump" in GDP in Q3 and Q4, the liquidation of commercial real estate assets and other debt will accelerate. At some point, price deflation will stop and asset prices will find a bottom. My view is that the post-deflation economy will remain sluggish with high unemployment for some time. I believe that, unlike Japan, we will eventually see inflation.

There are significant differences between our economy and Japan's and the comparison to Japan in the 1990s may not be entirely applicable here. The Japanese were reluctant to let banks and companies fail, but, despite a few notable exceptions, we aren't. This is a necessary requirement for recovery, and we are better at "creative destruction" than are the Japanese. Also, we have a more dynamic culture of entrepreneurship than Japan, making us more responsive to a recovery. However, the main difference is that Japan's debt was largely financed internally due to their very high savings rate in the 1990s (about 14%). While our savings rate will continue to grow, I do not believe it will keep up with rising federal deficits, and we will need to finance our national debt on the international markets. This will drive interest rates up and put pressure on the dollar.

Then I believe inflation will assert itself as banks renew the lending cycle. I believe the Fed will maintain its loose monetary policy in order to keep interest rates down to stimulate growth. Governments always find it expedient to create inflation to give people the impression that the economy is growing. The problem is that inflation will depress the formation of real savings necessary to finance growth, and like the 1970s, we'll see stagnation and inflation ("Stagflation"). If inflation gets out of hand, then, for a while we may see price and wage controls.

After that, who knows? Cut the money supply as Paul Volker did, and drive up interest rates and bring on a new recession? Continue to inflate? That's too far in the future and politicians don't think that far ahead.

September 15th, 2009 | Tags: economic megatrends, economic recovery, long term analysis | Category: Uncategorized | 21 comments - **(Comments are closed)**

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September 15, 2009 at 1:03 pm

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September 15, 2009 at 7:20 pm

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September 16, 2009 at 2:56 am

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Lloyd G.
September 16, 2009 at 4:21 am

Jeff-
Good post. Long term, your 'Megatrend No. 7' — and how the gov't deals with it — will control the direction of this country. Of course that assumes that this country, as we know it, survives Megatrends 1-6.
There are some social/political wild cards out there:
As you point out, things in China are not as rosy as gov't pronouncements would have us think. There are millions of unemployed. There have been bloody riots. Ethnic tensions.
There are strongly negative social undercurrents in this country — what are the millions of unemployed people going to do when their unemployment benefits run out? People who are stressed out and desperate do not tend to be rational.

Economic Megatrends That Will Drive Our Future | The Daily Capitalist | Youth Political Blog
September 16, 2009 at 8:32 am

[…] Read more here: Economic Megatrends That Will Drive Our Future | The Daily Capitalist […]

Jeff Harding
September 16, 2009 at 1:35 pm

Lloyd, thanks for the compliment. I meant this to be a major piece and it took a lot of work.

brysonr
September 16, 2009 at 2:25 pm

Jeff this may be your best post since you began the site. I probably say that because I understood and agreed with everything you said. It is hard to argue effectively with any of the positions you proposed. The summary is a rather ugly and depressing scenerio. It won't all come true but unfortunately their are too many hurdles to cross without tripping on at least one. Again good work. I will e mail to a number of pollyana friends who will probably squirm.

BryceC
September 17, 2009 at 12:18 pm

"Newly disclosed documents reveal that the Johnson Administration knew that Medicare cost estimates given to the public were a lie, but LBJ was afraid it wouldn't get past Congress if the true costs were known."

I have heard nothing about this, is there a place I can read about it online? Thank you,

Jeff Harding
September 17, 2009 at 12:57 pm

Bryce:

See: http://www.npr.org/templates/story/story.php?storyId=112234240

Lloyd G.
September 17, 2009 at 2:34 pm

On the subject of our betters not telling us everything:

http://www.cbsnews.com/blogs/2009/09/15/taking_liberties/entry5314040.shtml

Economic Megatrends That Will Drive Our Future - Politics and Other Controversies - City-Data Forum
September 17, 2009 at 4:53 pm

[...] Economic Megatrends That Will Drive Our Future Megatrend No.1. The culture of consumption is broken and won?t return to former levels. This is the key to everything. Megatrend No. 2. Consumers will continue to increase savings to prepare for retirement. Megatrend No. 3. Declining U.S. consumer demand will continue to negatively impact the world economy. Megatrend No. 4. Deflation will continue for some time. Megatrend No. 5.Home ownership rates will decline to more historical levels of, say, around 66%, down from the high of 69% during the boom, which will keep a lid on home prices. Megatrend No. 6. Government stimulus and recovery programs only delay recovery and deepen the pain for workers. Megatrend No. 7. Massive federal deficits will double the national debt, result in higher taxes, and will act as a permanent drag on the economy. Economic Megatrends That Will Drive Our Future | The Daily Capitalist [...]

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September 17, 2009 at 5:58 pm

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October 1, 2009 at 4:34 pm

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[...] might ask, with all this faith in Keynesian policies, why aren't they working? Why are we still having these problems? And, why aren't we doing something different than [...]

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Calvin
February 11, 2010 at 10:46 am

Where do you get your Personal Consumption numbers (as a % of GDP). Using BEA.gov I get a much higher percent than you do in 1980 and a much lower number in 2007.

Thanks.

Jeff Harding
February 11, 2010 at 3:18 pm

The chart comes from FRED, the St. Louis Fed's chart service. The info comes from the BEA. The chart was constructed to show YoY change, and it is a 10-year span.

Economic Megatrends That Will Drive Our Future
March 6, 2010 at 3:23 pm

[…] By Daniel at 6 March, 2010, 7:23 pm ——————————————————————————————————— from the article, http://dailycapitalist.com/2009/09/15/economic-megatrends-that-will-drive-our-future/ […]

Mike
June 27, 2010 at 5:09 pm

After many years of thought and reading on the topic, in a little more detail:

- I think we're experiencing monetary deflation, and have since about a year after the Fed decided to stop publishing M3 numbers (probably not coincidentally). Lots of factors, but big ones are de-leveraging of debt, and our horrific trade deficit.
- That said, there is so bloody much real money sloshing around, it will take a long time before we see price deflation, as a result of the monetary deflation, if at all. Major factors are causing food supplies to dwindle world wide, we're still increasing subsidies for corn ethanol and other 'bio mass' fuels, which are steadily decreasing the amount of farmland in use for food production. its a long winded way of saying that we'll probably see increasing food prices, and increasing oil prices, even though we're amidst monetary deflation, due to external forces.

David Redick
September 17, 2010 at 6:11 pm

Jeff: I just discovered you!! Great site. May I send Edition 3 of my 'Monetary Revolution-USA' book to you for review? See some text of 2nd edition at Parts 1 and 2 in the left margin of my Forward site.
Rgards, Dave

The Official Blog of Legacy Holdings International; Creating Wealth thru Alternative Investments, Trading & Commodities
November 4, 2010 at 11:27 am

[…] I wish to point out that this in another forecast of mine that has been accurate. In my article, Economic Megatrends That Will Drive Our Future, in September 2009 (originally written July, 2009), I said: Megatrend No. 5. Home ownership rates […]