Armchair Economics

Perspectives from an economic everyman

The Perfect Economic Storm

July 2011

"We don't have a precise read on why this slower pace of growth is persisting." – Ben Bernanke, Federal Reserve Chairman in a *New York Times* article from June 25, 2011.

Is the Armchair reading this right? No human being on the planet has access to more economic data, more technology, better-trained minds to analyze an economy, and greater ability to move markets than Ben Bernanke. Who in the world is better prepared to understand the economy than Bernanke? Looking through the most sophisticated glasses, supported by billion dollar budgets, thousands of employees and the most well educated economic minds in the world...Wait, wait, wait...I've got it...That *is* Bernanke's problem!

Bernanke can't get a precise read because of this enormous crowd between him and the problem. Bernanke's economic forest is so crowded with trees it's blocking his vision. The weight and baggage around him is so great, he can't rise above the economic forest's canopy to get a clear view.

The Armchair doesn't have this problem. There is no massive infrastructure blocking his view or holding him down, preventing a look at the forest from above the trees. Unencumbered by institutional baggage, the Armchair can fly above the canopy for that clear view…or at least for the Armchair view. So what does the Armchair see? He sees a perfect economic storm.

Let's remember in the original "The Perfect Storm" story, calamity was actually the result of several independent weather systems on a collision course. This same type of phenomenon seems to be brewing in our economy. We have four economic storms collecting and hovering over our Developed Market economy.

Storm one is the Technology Hangover, where technology is destroying jobs faster than our economy can replace them. Job destruction is coming from the outsourcing of labor to cheaper markets, as well as the replacement of labor with both automation and computerized information management systems.

This is the most powerful and menacing storm. It seems to be growing stronger by the day thanks to the global adoption of competitive market based economies and the massive proliferation of innovation in information management and communication systems.

This is why large corporations with sophisticated technology are flush with cash. They are either using technology to facilitate outsourcing labor, or they are directly replacing labor with technology. Labor has become a cheap commodity, evidenced by the plateau of personal earnings over the last ten years.

The U.S. is moving faster and faster into a world needing less and less labor, yet it is labor wages that drive consumption. This is our most fundamental issue, the most dramatic change affecting us, and one not apparently dissipating any time soon.

Storm two is the maturation of the rural agrarian to urban production economic transition. This transition has been taking place since the dawn of the Industrial Revolution. During their developing days, today's Developed Market economies, like that in the U.S., were naturally lifted from this economic transition.

The move from farm to factory required building new infrastructure. The actual construction of that new infrastructure was itself an economic stimulus, as new stuff that didn't exist before required building. And more stimuli were born from the gains in productivity from that new infrastructure.

But now the Developed Markets are developed. The economic rewards of building productivity-inspiring infrastructure to support a growing production oriented economy are behind us. Now we are forced to maintain these infrastructures in order to NOT lose productivity and to support the value of infrastructure assets that support our banking and financial systems.

Allocating capital to infrastructure maintenance is nowhere near as economically inspiring as allocating capital to create that original infrastructure. The Developed Markets are experiencing a diminishing rate of return on their use of capital…because they are developed. We have passed the maturity point of the rural agrarian to urban production economic transition.

Storm three is the contraction of production's contribution to our overall GDP. In the Armchair's "The Elephant Run Amok," we learned that the production component of U.S. GDP had fallen from about 55% between 1930 and 1980 to 36% in 2009. As production's GDP contribution fell, services obviously rose. Why did production's share of GDP fall and services rise?

In part, it happened because we had completed the farm to factory economic transition. We had already constructed the great majority of needed infrastructure and already captured its productivity. We were developed, no longer in the developing phase. But two things also had a thunderous impact on production's plateau and services' growth: the 1970s oil price shock and the rise of technology.

In less than a decade during the 1970s, the price of oil increased almost 10 fold. As producers were unable to control rapidly rising energy costs they naturally sought ways to reduce other costs, and technology helped them do so. Thus began the great outsourcing labor wave. And as technology became ever more capable, outsourcing expanded further.

As outsourcing labor grew, something had to fill the employment void. In came services. But services must have someone to serve, and production is the customer at the top of the economic food chain. So as production stagnated, we needed something else to fuel our economic "growth." This something else became the fourth economic storm.

Storm four is actually the consequence of each of the first three storms. Because technology is destroying jobs faster than our economy can replace them, and because most all the economic benefit of the farm to factory transition is behind us, and because production has become a shrinking part of our economy, we had to borrow money in order to maintain "growth." As the first three storms grew in magnitude, only by borrowing could we prop up our growing services economy.

We didn't do this with a conscious understanding of the economic storms at our shore. Keynesian theory suggested we needed to stimulate our economy during periods of cyclical weakness, so we did…A little here, a little there. But as our overall economy became less and less production oriented, we borrowed more and more.

The government borrowed to stimulate during the economic soft patches and to support our growing social services infrastructure. And we borrowed to protect American interests, the interests of her allies, and to finance our post World War II role of global policeman.

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After a few decades of entitlement and debt creep, the floodgates blew open with financial innovation. Since we weren't producing enough, we figured out how to increase the leverage on our infrastructure by increasing the leverage on just about any asset around. Soon it took more and more debt to sustain the economy, to hold back these economic storms from their destructive power.

There is little to risk being in the Armchair, so let me predict that neither austerity nor tax increases will be the answer to our challenges because this is an enormous structural, not cyclical, problem. We are past the farm to factory transition. We are past an economy based upon production. We are moving labor more and more to the variable cost side. Services can't be the foundation to a giant global economy with the cultural and educational dispersion of America's population.

This is what Ben Bernanke can't see. He can't see it because he's using economic tools that applied to the farm to factory transition, which is now complete. He can't see it because we have rationalized that a service and consumption economy is sustainable. He can't see it because he's been trained to believe properly managing the money supply and interest rates can manage an economy through any situation.

Ben Bernanke can't get a precise read because he's sitting in the middle of the forest surrounded by billions of dollars, thousands of staff and hundreds of economic experts trained for a production based economy that has passed us by. And with the massive amount of fixed costs now required to support a fading production based economic infrastructure, combined with an enormous amount of debt, we have little flexibility to change, unable to make the economic transition to a post-production economy. We also don't even know what that future will look like, because we only know what we know, and we don't yet know that which we have yet to experience.

How can monetary, fiscal and regulatory policy work when they were developed for a production-based economy that has now lost is relevance?

Economy is an ever changing, ever evolving organic creature. The perfect economic storm is upon us for one likely reason: we are in the middle of a dramatic transformational period, similar to moving from being a teenager to an adult. A new organic economic era is coming and our world will likely feel dysfunctional until the economic transition is complete. And all the experts will likely remain confused if they continue using analytical and policy tools from an economic era that has passed us by.

We are supporting infrastructure of a production-oriented economy that has become less and less relevant to our overall economy. That infrastructure supports our financial and economic system, so it's no wonder financial and government leaders are doing everything possible to abate these storms.

"ECB ready to reject Greek downgrade, Central Bank to select best credit rating" read a headline in the *Financial Times* on July 5, 2011. Is there any better evidence of our denial?

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