IS THE GLOBAL ECONOMY LIKE A “HOUSE OF CARDS”?

Michael L Schwartz, PE, PMP

HOUSE OF CARDS

Question to address:

Does the current economic crisis show that the global economy is like a “House of Cards”? That is: Is the Global Economic System structurally sound, or is it build on such a foundation that if one “building block” is removed, or damaged, then the entire structure will fail and collapse?

Introduction:

The Global Economic System had its beginnings millennia ago, when bands of hunter-gatherers would meet, by design or by happenstance, and barter for exchange of goods. Over centuries, as humans began to settle into, more-or-less, permanent habitats, trade of goods between distant locations came about. Barter became a very inconvenient way to exchange goods and services, and money evolved. Money, in this sense, is simply some agreed upon “asset” which all parties agree to use as a common form of payment. Different, geographically separated, villages, towns, and cites, began to use different “assets”, or different denominations of assets, as a medium of payments, and some sort of “exchange rate” needed to be developed. Over time, Trade Guilds, the forerunners of modern unions, were formed to protect its members and to set standards for the goods produced. With this, the beginnings of an Economic System began to form and evolve.

As travel, and transportation, became more common, and less expensive, trade and commerce spread. With this spread, the economic system became more complex.

Much more recently, as communication became easier between far flung locations, events in one part of the world quickly became known and affected, other parts of the world. This made the entire Global Economic Systems even more complex.

Discussion:

Financial crises are nothing new. There have been upward of a dozen, in this country, in the years since World War II. What is different about this one?

There are several issues that have converged in recent years, which did not occur in past crises. Some have been discussed, in the press, at great length, others very little, if at all.

In the last 50 years, costs of travel, transportation, and communication have decreased substantially. This has made populations more aware of, and has created a desire for, products that they previously did not know of. Because of this, there is much more international trade. As a result of this trade, the Global Economy has become a more complex entity, with more countries dependant on each other. A depressed economy in one country can affect a trading partner across the world by not being able to purchase its products.

In many cases, domestic industries, that did not previously have any substantial competition, are faced with completion from imports that they are not able to deal with. This is the case with the U.S. Auto industry, among others. The basic U. S. Auto industry business model was developed at a time of very little competition from imports. Basically, this was a captive market. In the last 35 – 40 years, a short time for a very capital intense industry, the market has changed substantially, and a new model is needed to successfully compete.

With increased communication technology, people can know, almost instantaneously, about events in any part of the world. Knowledge of these events can, and does, influence how, and where, people spend and invest. With the speed of modern communications, this can very quickly cause a negative situation to spiral downwards very quickly.

Easy credit for unqualified home buyers combined with lenders being able to “sell-off” mortgages as securities has created economic problems which have spread into many segments of the economy. In addition, the model used in the analysis of these loans did not consider what would happen if housing prices decreased. Easy credit has taken many forms: interest only mortgages, adjustable rate mortgages that “adjusted” too much too quickly, no down payment mortgages, and others. In many cases the only collateral on these loans was the value of the home. When home value fell, the loans were not backed and unqualified mortgagees were able to “walk away” with little or no financial loss. The mortgage lenders had sold the mortgages as securities and they had little loss. The loss came in the Stock Market, with unsecured, virtually valueless “assets”.

The home mortgage issue has spilled over into other areas, as well. Home appliance manufacturers have seen a reduced demand for their products. Furniture and home furnishings sales are down. Credit has tightened substantially. The tightened credit has improved one industry, however. Pawn shops are doing more business, even in largely affluent communities, where “large ticket items” are being pawned for short terms loans.

Many more people, today, own stock than 40 or 50 years ago. This is not necessarily bad. The problem is that many of these stockholders do not really understand basic investment principles, nor do they really research the stock market for trends. So when our 24/7 instantly available news shows anything that looks like a "downturn" many people begin to panic and sell when they should be holding or buying.

Finally, the "Baby Boomer Generation", which is little talked about, has a potentially huge affect on the economy. This has not happened before, where one demographic group is such a large proportion of the economy. "Baby Boomers", that group of American children born in the years following World War II, between 1946 and 1959, number seventy-six million, constitute nearly one-quarter of the U.S. population, today. This is also a very affluent generation. From the mid-1960's through the mid-1980's, at which time the "boomers" represented approximately 40% of the U.S. population, members of this generation were buying their fist cars and homes. Suburbs, roads, and other infrastructure were built to accommodate this. Along with this, other industries flourished: home appliances, furniture, and so on. (There is sometimes noted a second, somewhat smaller, cohort of baby boomers born between 1959 and 1964.)

Baby boomers are now in their 50's and 60's, a time when, typically, spending on durable goods slows down considerably. Many of the capital intensive industries are still operating on business models of 30 and 40 years ago, when sales were much stringer.

Additionally, baby boomers are coming close to "normal" retirement age. They are, in general, less interested in "risky" investments, i.e. the stock market, and looking for more stable, secure places to save and invest.

Many other countries had to rebuild their industrial base and there infrastructure in the years following World War II. This has long been accomplished. As in the U.S., businesses that based the business models on those scenarios, and have not yet adapted them to the current situation, will also be suffering in economic downturns.

These situations, to a greater or lesser extent, exist in countries around the world. These situations, for the most part, are not unique to any one country. Additionally, the U.S. is still, arguably, the largest economy in the world. So, when a downturn, or upturn, happens in the U.S. economy, there is often a ripple effect in the Global Economy.

Conclusions:

The Global Economy is basically structurally sound. However, as with our physical infrastructure, it needs maintenance and repair.

Our Global Economic system has grown and evolved over many centuries. For much of that time, technology has changed very slowly. For the past century, technology has grown by “leaps and bounds”. Along with this, the global economy has become much more complex due, in part, to the growth in technology and, in part to many more countries taking part in international trade.

Companies need to revisit, and revise, their business models more often. They cannot operate on the belief that the status quo will never change. They must adapt to an ever more rapidly changing business environment.

Financial markets must not be able to introduce products such as the "easy credit" mortgages. Mortgage issuers must not be able to sell these products as securities, they must retain them and take the risk on loans they initiated and approved.

Media reporting should include more than just "sound bites". There should be in depth explanations of what market turns really mean. This should be on "local" news outlets, not just on specialized financial news outlets.

What about the "Baby Boomer Generation". If the above maintenance and repair are enacted, and adjusted, the effects of a single large demographic group should be mitigated.

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