



The View from 30,000 Feet

The U.S. Economy was Sick Before the Financial Crisis

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The financial crisis and “Great Recession” of 2007-09 were symptoms of a larger and more ingrained set of economic challenges that have been building over the last 25 years. The Central Bank’s policy responses to the crisis are not addressing the real problem and therefore have only yielded marginal results. Unfortunately, these incorrect policy responses are also creating distortions and risks that if allowed to continue could throw the global economy back into another financial crisis.

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EXECUTIVE SUMMARY:

The U.S. economy was broken long before the financial crisis and “Great Recession” of 2007-09. The crisis and corresponding recession were therefore symptoms of a much larger and far less understood structural problem. Failure by economists, analysts and Central Banks to properly understand these underlying issues are resulting in misguided policy responses which are not only yielding insufficient results, but a growing list of dangerous unintended consequences as well.

The introduction of workers from China, India and the former Soviet Republic in the early 90s doubled the global labour pool almost overnight. This massive influx of new workers from the emerging markets were willing to work for lower wages compared to their North American and European counterparts, which created a “labour arbitrage” opportunity for market savvy corporations. By moving their manufacturing bases to these emerging markets, companies paid significantly less on their labour inputs (wages) and therefore enjoyed a dramatic increase in profitability. The benefits of “outsourcing” were so significant that a large majority of companies had to follow suit to ensure that they remained competitive within the global economy.

The positive impacts from outsourcing were enjoyed almost immediately as prices on consumer products declined and stock markets soared, spurred on by record high corporate profits. The negative consequences of outsourcing (while present) were far less obvious. Hidden behind the record markets and surge in consumption were job losses, declining relative wages, a hollowing out of the manufacturing base of the economy, a decline of the middle class through income inequality, and an increasing reliance on debt to maintain a falling standard of living.

The economic and housing market bubbles that burst in 2007 were simply symptoms of a bigger and more complicated problem that had finally hit a tipping point. Consumers had been spending beyond their means for many years and had accumulated an unhealthy amount of debt in the process. Contrary to the headlines and economic reports we read today, “The Great Recession” has not ended for most citizens. The policy response of choice by Central Banks has been to focus on increasing the value of the stock and housing markets in the hope that a trickle down “wealth effect” will stimulate a more sustainable economic recovery. Unfortunately, there is a volume of research showing that wealth effects on the overall economy are marginal at best. Focusing solely on the level of the stock market has led to the income inequality gap between the “haves” and “have not’s” to surge to levels not seen since just before the Great Depression of the 1920s.

Failure to properly identify and resolve the true cause of our economic problems has created a massive disconnect between the stock market and the economy, which in turn has greatly increased the implied risk levels faced by today’s investors. While optimistic headlines promise better times ahead, the reality is that the U.S. consumer (and therefore economy) continues to suffer from an unresolved sickness which makes a full “recovery” impossible.

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