Adam Smith's Global Speed Bump

The current recession in America is different from the last one. It has lasted longer and sunk deeper. More important, it is a part of a global recession which may repeat itself again and again in the future. This article is written to suggest that we can warn about such calamity at least two to three years ahead. We would be able to avoid much of the human sufferance and economic damage in the world.

A world size speed bump:

In February of 2005, Brazilian mining company, CVRD secured a shocking price increase of 71.5 percent for the iron ore it sells to Japanese steel companies. The mining company was able to get away with such an outrageous increase because the world demand for iron ore had surpassed what all the major mines could produce. The Australian mines got similar increases from Chinese buyers. Oil prices have gone up just as fast for the same reason. After decades of fast growth, our demand for raw materials might finally have outpaced the supply on this earth. The price of all the commodities has shot upward steadily since 2006. It was a broad based persistent trend. At this point, the high demands cease to increase the supply; it only causes the exaggerated values of the same supply. The exaggerated values are what we call bubbles. We start to see bubbles of many kinds all over the world. At this time, the world has hit an Adam Smith Speed Bump which means to slow down the economy and rebalance the supply and demand.

If the world economy slowed down a little in 2005 and 2006, the supply and demand could have been rebalanced quickly. The world economy would have had landed softly on the other side of the speed bump. Instead, all the nations of the world were obsessed with the same universal goal of growing as fast and as long as they could. China continued with her double digit growth, India was not far behind. The rich oil exporters spent like there was no tomorrow. America had the red hot housing boom for some time. Most of the other nations were also growing fast. The world had not slowed down. Instead, we pushed the speed bump higher and higher until the inevitable hard crash.

The Global Nature of the American Recession

The American economy has been very sluggish after the collapse of its housing market in 2006. In the good old days, we would have seen prices going down quickly and a recovery starting soon after, but things have changed: When America was down, other large countries continued to expand and buy more, they continue to drive the commodity prices higher and higher in 2006. America ended up having bad inflation in a sluggish economy. Gasoline prices were higher and the manufactured goods from other countries became more expensive. The weight of inflation pushed us into recession near the end of 2007 and throughout 2008. We had a bad experience with stagflation. There was no fast recovery.

America buys a tremendous amount of manufactured goods from China. Since 2005, the costs of such goods have gone up more than 40 to over 50% percent, depending how much loss the Chinese exporters could absorb. Only a part of the increases are related to raw material prices. More than a half of increases are caused by structural adjustments, over 20% in appreciation of the Chinese Yuan, 5% to over 10% due to the removal of tax rebates, and a new labor law that would significantly add to the costs of manufacturing in China for years to come. Considering the huge amount of goods sold to America, the huge price increases must have impacted us badly. The $4.00 per gallon gasoline was a great shock. But the higher prices for goods from China will impact us for years to come. These structural adjustments are necessary and inevitable. But they came too much and too late in the process. They act like a huge hammer, knocking thousands of Chinese factories out of business and slowing down the Chinese economy abruptly in 2008, and drawing America and the world down further and longer.

All the major economies in the world took a sharp nose dive with China in the middle of 2008. The demands for resources ended and the commodity

Inflation was no longer a problem, but America and the world were already seriously wounded. American export companies and multi-national companies which did rather well in the early part of 2008, started to suffer along with their fallen foreign markets. America has actually fallen lower in the second half of 2008 even as the inflation subsided. Welcome to the new global economy. We no longer can understand America without knowing the world.

The Recovery and a Dangerous Future

The most important question we want to ask is when will our economy recover? Let see what we have in our favor and what we don't:

What we have:

1. Low inflation; with the world in recession, we will have a low inflation environment for a while. That is a necessary, if not sufficient, condition for any meaningful recovery.
2. In the middle of a crisis, it is easy to forget that the majority of businesses in this country are still standing. Even thousands of community banks are fairly healthy. They are the foundation of our economy and the basis for our recovery.

What we do not have:

1. Confidence: Consumers and businesses have lost their nerve. Businesses keep on laying off workers to prepare for the worst. Consumers, insecure with their jobs and the shrinking value of their assets, are in no mood to spend money.
2. Our whole financial system is in bad shape.

What we may have to do:

1. There is no easy way to fix our financial system as long as we are in recession. Not only are subprime loans stubborn problems, the value of prime assets also shrink with the economy. We should duct tape

the problems for now and fix them after the economy begins turning around. How about temporarily freezing the value of all performing loans, the ones that continue to earn interest. That will slow down the free fall of bank assets because most of their loans are still performing. The banks will not hesitate to make new loans if the value of their assets is likely to hold. It also gives banks incentive to restructure troubled loans and keep them performing. After the economy recovers, and only after the economy recovers, can the financial system repair itself with profits and appreciating assets.

2. What Americans need most right now is confidence. If our political and business leaders can boost the morale of this nation, we will be on our way to recovery very quickly.

The recovery of America and the world economy will not be a "happy ever after" story; None of the nations are likely to change their old goal of expanding fast and long. In the short term, countries will spend maddening amounts of money to stimulate their faltering economies. They may very well stimulate themselves into building the next Adam Smith global speed bump within a few years. Fortunately, the next global recession, if it ever happens, does not have to be as harmful. We have learned enough to be able to forecast these events two to three years ahead of time, just like we forecast hurricanes and tsunamis.

Adam Smith Index - an early warning system

This author has constructed a simple 1-9 scale, called Adam Smith Index, in 2005. 1-3 trigger a yellow warning. (2005) "1" calls vigilance. By "3" you should have all the emergency planning completed. 4-6 are red warning, a global slowdown is inevitable. (2006) It would be the time to implement all the emergency plans. They may include cutting costs, selling assets or stocks, paying down debts, establishing a rainy day fund, etc. 7-9 is a warning "not to panic". (2007-2009) Things are bad for everybody. But you have done so much to prepare for this. just calm down and think hard enough, there are still a lot of things you can do to help yourself. How about negotiate a cheaper long-term lease for your business?......

This author relied heavily on the world commodity prices to construct his index. Oil and base metals are particularly useful because they are true global measures. He looks for the sharp price increases as well as the wide based persistent trends. Other information, such as structural adjustments in the global economy and government policies are also closely watched. If, unfortunately, this author would has to issue a new warning in the future, he would spell out his Adam Smith Index in greater detail.

Wen-lung Chang, Ph. D.
Originally posted @ www.v8tools.com
2/23/2009

Home