



The Next Financial Crisis

By Richard W. Rahn

CONTINUED DESTRUCTIVE ECONOMIC POLICIES MAKE IT INEVITABLE

The end is near — depending on how you define "near" and where you live.

A couple of weeks ago, hedge fund legend Stanley Druckenmiller gave an important talk arguing that the crisis is about to hit and investors should liquidate their equity holdings. He and others who have similar views have been the subject of much debate among economists — more of it about the timing of the next global and U.S. downturn and not so much about whether it will come.

The crisis has already hit many — depending on where you live and what assets you hold — and will eventually spread to billions of others, including a very large segment of the U.S. population. If you live in such diverse places as Greece, Brazil and Puerto Rico, you are likely to have already seen a large reduction in your real income and standard of living. If you are retired and living off interest on your savings, you have seen a reduction in your income as a consequence of the very low interest rates engineered by the Federal Reserve.

The fundamental problem is most countries are experiencing little or no growth as a result of excessive government spending (particularly on transfer payments), and destructive regulations and tax policies. The unwillingness of the

politicians (and their voters) to cut back on spending and regulation has led to an explosion of government debt, which is not sustainable at current levels of economic growth. This, in turn, is fueling a demand for more government spending (more free stuff) and thus more debt.

People buy U.S. government bonds and notes because they believe they have real value. The value comes from the fact that the government has the power to extract real wealth from the private sector, mainly through taxation, to pay the interest and principal on the debt. This issue was settled when the U.S. government put down the Whiskey Rebellion (1791-94), with George Washington showing that he would use force to collect the tax on whiskey. The power to tax is supposed to belong to Congress, but when the Fed sets interest rates below what the market would set and even below inflation, it is, in effect, imposing a wealth tax — as all who have savings accounts have noticed.

The U.S. government is not going to explicitly default on its debt because it sells its bonds in its own currency and prints its own money — even though the real value of the principal and interest can be reduced through inflation. Countries that do not sell their bonds in their own currency, such as Greece with euro-denominated bonds or Argentina with U.S. dollar-denominated bonds, can and do go into explicit defaults because they run out of foreign currency to pay the interest and principal. U.S. states, cities and territories, like Puerto Rico, can also default on their debt because they cannot print the U.S. dollars in which their bonds are denominated.

What we are seeing at the moment is a slow-motion crisis where real incomes in a number of countries are stagnant or dropping because of the fall in commodity prices and the rising cost of debt service. Debt service is "paid for" through explicit tax increases, inflation or implicit wealth taxes on savers as explained above. More countries are likely to experience major income reductions due to the cost of debt service. For instance,

the Italian banking sector is saddled with debt that it is unlikely to be able to service, and the government debt is well over 100 percent of gross domestic product. A small shock might well cause major Italian banks to default, which could cascade throughout Europe. And no one knows to what extent the German taxpayer will be willing to bail out the Italians.

At the moment, many governments are eating their seed corn — that is, destroying real wealth in their economies, with far too many people consuming more than they produce and productively invest. As the Greeks, Brazilians, Russians and many others are learning, the real value of the wages and government transfer payments they receive will fall until the total value of their collective output once again exceeds their consumption and depreciated capital. At that point, their economies will begin to grow again.

In the United States, many of the politicians who shout most loudly about wage stagnation are the very ones who were the most aggressive in putting in the destructive spending, taxation and regulations that caused the problem. Both democracies and socialist totalitarian states are prone to cycles of excessive spending — which either leads to reform or destruction. For example, Venezuela once was a prosperous democracy and has the world's largest oil reserves, but now the people cannot obtain basic foodstuffs or even toilet paper, as a result of their socialist experiment.

No one can forecast the future with certainty. But I stand by my January prediction of a recession by the end of this year, because those in control continue with their growth-destroying economic policies.

Richard W. Rahn is on the board of the American Council for Capital Formation and is chairman of Improbable Success Productions

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