

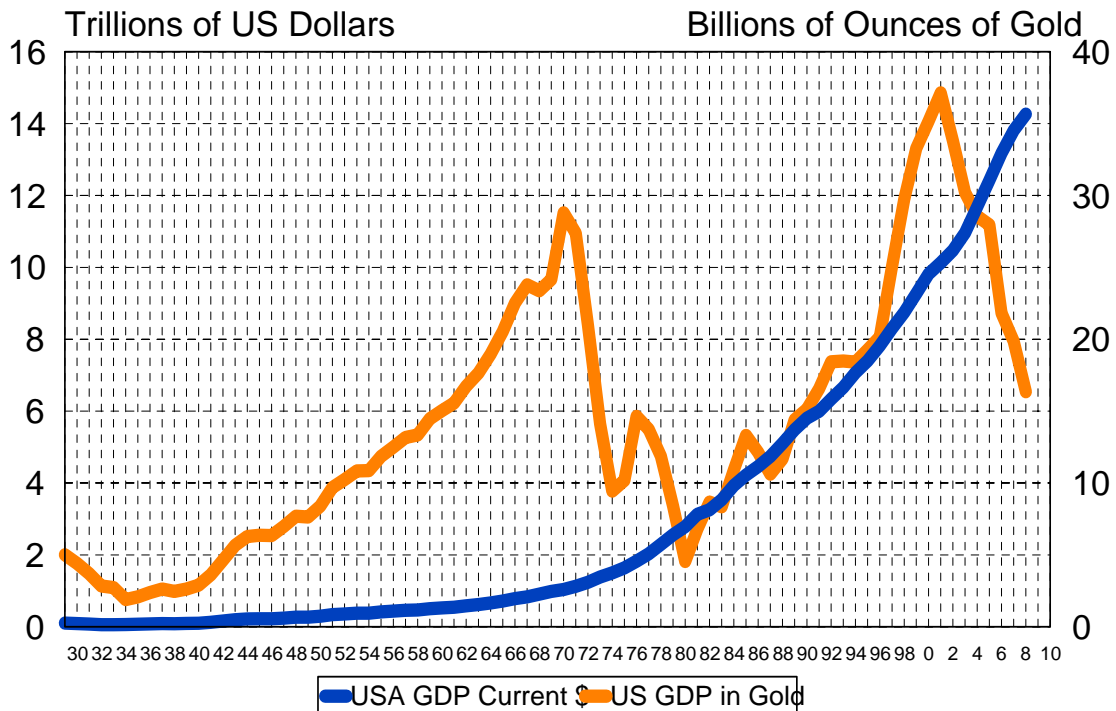
# A Brief History of the Post-World War II US Economy

By Kenneth N. Matziorinis, Ph.D.

The Chart below shows what US economic activity would look like if the world was run on a pure gold standard, i.e. we used gold as a medium of exchange, store of value and unit of account. A big economic post-War boom starting in 1940 and ending in 1970, followed by a major contraction between 1970 and 1980, followed by a new period of expansion from 1980 to 2001 and since then a major economic decline, of which the current global financial and economic crisis is a symptom.

The US was forced off the gold-exchange standard in August, 1971 and what followed was a period of unprecedented exchange rate instability, high inflation, industrial decline and high unemployment and culminated with a run on the US dollar when in August of 1979 gold reached around \$750 US an ounce.

### US GDP IN NOMINAL US DOLLARS VS. US GDP MEASURED IN GOLD, 1929 - 2008



The recovery was engineered by Fed Chairman Paul Volker. To tame inflation and re-establish the credibility of the US dollar he raised interest rates to an unprecedented high. This led capital to flow to US-denominated assets, which reaffirmed the US dollar as a safe store of value, means of payment and unit of account and placed the US economy on a renewed path of economic prosperity that culminated with the roaring 1990s prosperity of the Clinton years. One fortuitous unintended consequence was that by forcing a global contraction in the early 1980s, it pushed down commodity prices including that of oil and this undermined the Soviet economy whose main hard currency export was oil, precipitating the collapse of the Soviet Union and the end of the Cold War.

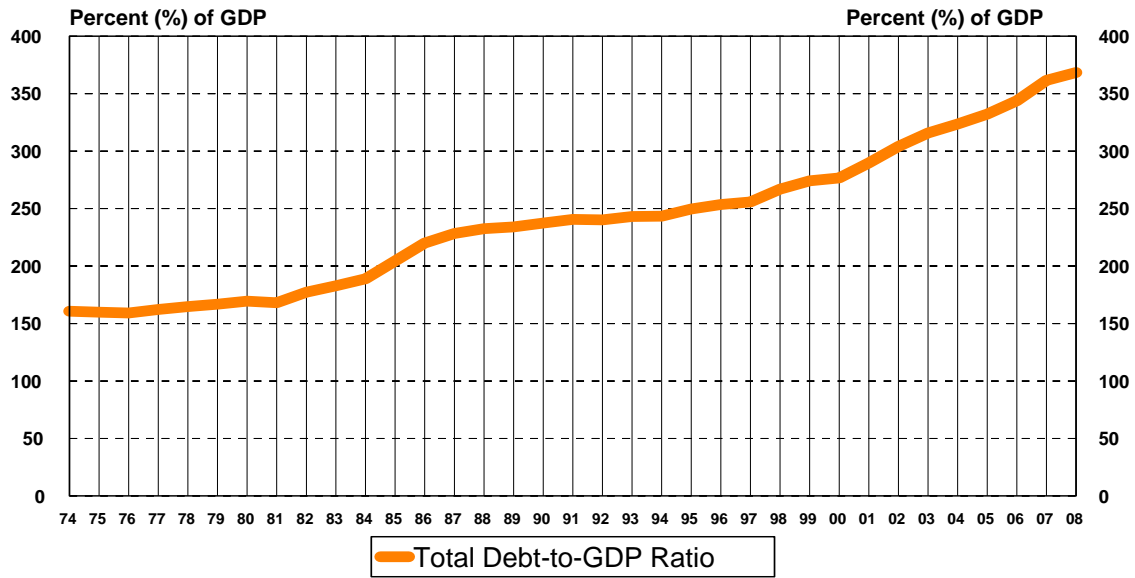
But, there was also another unintended and insidious consequence to Volker's policy of using interest rates as a tool to tame and control inflation. It forced real interest rates through the 1980s and early 1990s to historically unprecedented high levels. The consequence was that debt levels –at all sectors of the economy, household, business and government including sovereign debt–started slowly but steadily to rise. As long as debt levels were manageable, borrowers continued to borrow and lenders continued to lend. At the same time, the liquidity that had been created by the Fed started flowing to asset markets instead of product markets, so we got price stability in product markets but asset inflation in asset markets which has led to the increased frequency of financial bubbles and emerging market financial and debt crises starting with the Latin American debt crisis of the early 1980s, and followed by the stock market crash of 1987, the implosion of the Soviet Union and its periphery, the Savings & Loan crisis of the early 1990s, the commercial real estate crisis of the late 1980s and early 1990s, the 1994 Mexican crisis, the 1998 East Asian and Russian crisis, the LTCM crisis of 1999 and then the dot.com and technology stock meltdown of 2000-01 and subsequently the global housing boom and bust and the current global financial and economic crisis.

The dark side of Paul Volker's policies was the build-up of debt since 1980 to the point where total debt (private and public) in the USA has risen to 370% of GDP from 168% of GDP in 1981 (see Chart below). At the same time, the US ceased being a net creditor nation in 1986 and has now become the world's biggest net debtor with net foreign liabilities close to \$4 trillion and a foreign debt-to-GDP ratio in excess of 23%.

The decline in US economic fortunes that started in 2001 did not become too apparent in the early years of this millennium because Alan Greenspan slashed interest rates to unprecedented lows in order to maintain growth in the US economy. What he accomplished, however, was only to buy time and forestall the inevitable downturn. The US economy experienced only a mild recession in 2001 and then growth resumed, albeit at a slow pace initially until it picked up steam by 2004. But the bulk of US growth the last eight years has been due to borrowing, Low interest rates encouraged households to borrow at an unprecedented extent to purchase housing and other consumer durables

such as SUVs and to refinance their home equity to extract additional financing. This debt binge climaxed with the issuance of sub-prime securities that eventually boomeranged and became an albatross on the US securities market and financial system.

**US Total Debt-to-GDP Ratio: 1974-2008**  
 Federal Reserve: Flow of Funds Accounts, June, 2009, Z1



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The bulk of economic growth in the 2001-2008 period was based on borrowing and driven by the credit creation mania at bargain basement interest rate levels. It was not driven by natural forces, such as capital investment or export growth or enhanced global competitiveness. It was not meant to last. Since the contraction started in December of 2007, all the jobs created since the end of the 2001 recession have all been erased.

I expect that the current downturn in US output as measured by gold that started in 2001 will end by 2012, which suggests that the worse may still lie ahead of us. Either output in real terms will continue to fall or prices will at some point begin to rise. I expect the latter, which means that the moment the downturn ends and growth resumes, be prepared for a serious bout of inflation and currency instability that will send gold higher and the US dollar lower, thus precipitating a run on the dollar and a possible collapse of the US-dollar based international monetary system.

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