

PAPER # 2: The Global Financial Crisis Instability, Social Disorder and International Realignment

Introduction

The financial crisis that began in September 2008 threatens to break the illusion of global peace and good order that has prevailed since the fall of Communism. With banks failing and markets in disarray, national and ethnic tensions are likely to intensify. Anti-market socialism, previously discredited, is staging a comeback. With a new socialist bloc emerging in Latin America, a resurgent Russia together with an economically disillusioned China could launch a new Cold War; and the United States is far from ready. Should this happen, economic and political optimism would give way to the grim calculus of economic warfare and ideological confrontation. After the fall of Communism, investors and businessmen envisioned an era of peace and stability. They assumed that market democracy would spread throughout the world, facilitating a prosperous global society. Things have turned out differently. Today's economic downturn, therefore, signifies a turning point. As prices fall and unemployment rises, political unrest and international tensions are bound to flare up. The peaceful, well-ordered environment in which we live can no longer be taken for granted.

Science as Prediction

As of November 2008, we are at the beginning of the most serious financial crisis since World War II. It is a crisis that was predicted by some, but unforeseen by many. It is important to consider the thinking of those who anticipated the present crisis. For convenience, these fall into three general categories: (1) Cycle theorists; (2) the Austrian school; (3) Financial experts.

Taking up the first category: Some economic theorists hold that economies follow a cycle, like the seasons. There is spring, summer, fall and winter. The Russian economist, Nikolai Dmitriyevich Kondratiev (4 March 1892 – 17 September 1938), proposed the theory that capitalist economies have long term growth cycles followed by depressions. In 1938 an accountant named Ralph Nelson Elliott developed what he called "the wave principle." According to Elliott, crowd psychology (including investor psychology) moves from optimism to pessimism to optimism in a cyclical fashion. A leading disciple of Elliott wave theory, Robert Prechter, warned that the market optimism that began in 1983 would one day turn to pessimism. "I am writing this book now," wrote Prechter in 1995, "because I believe that another financial sea change is at hand." He predicted the prosperity of 1983-95 would end in "the biggest financial catastrophe since the founding of the Republic." Prechter was mistaken in the timing of his prediction, but this does not mean cycle theory is without merit.

There are scientific grounds for saying that a given period of prosperity will end, just as day follows night. Empirical observation shows that many processes are cyclical; that wars follow peace, death follows life, and spring follows winter. The economist Joseph Schumpeter argued that cycle theory is not merely “a psychology of crises,” but a theory of “an objective chain of causation which runs its course automatically....” According to Schumpeter, periodic depressions are necessary to economic progress. As such, they are inescapable. New companies and new methods must replace old companies and old methods. This is the celebrated process of “creative destruction” in which financial crashes and depressions pave the way for rapid advances. In the wake of a depression, wrote Schumpeter, “the economic system needs rallying before it can go forward again; its value system needs reorganizing. And the development which then starts again is a new one, not simply the continuation of the old.” What is poorly understood, argued Schumpeter, is that every boom “means distress for many producers.” New products overtake old products, but not immediately. The economy is gradually restructuring itself throughout the boom period. Finally, new efficiencies cause a fall in prices and the boom is terminated. Credit deflation follows, and a depression occurs. According to Schumpeter, “the boom ... makes an end of the boom, leads easily to a crisis, necessarily to a depression....”

Taking up the second category: The Austrian School of Economics started when Carl Menger solved longstanding problems related to the theory of value in 1871. The Austrian School was so effective in its analysis, that in 1929 two Austrian economists predicted the financial crash and subsequent depression that followed. In February 1929 Friedrich Hayek wrote a report that stated: “the boom will collapse within the next few months.” Ludwig von Mises turned down a position with Kreditanstalt Bank in early 1929 with the explanation, “A great crash is coming, and I don’t want my name in any way connected with it.” Mises and Hayek later wrote books that influenced such figures as Margaret Thatcher and Ronald Reagan.

The Austrian teaching on “trade cycle” theory is fairly straightforward. An excessive expansion of the money supply typically leads to an unsustainable credit-driven boom. The false boom thereby engendered signifies a period of mal-investment, so that the economy is damaged. The subsequent recession or depression is, in fact, a period of healing. The Austrian School warns against any attempt to interfere with the healing process of a recession/depression. About this, Ludwig von Mises wrote: “the interventionists ascribe to the government the power to correct the operation of the market economy in such a way as to bring about what they call ‘economic stability.’ These interventionists would be right if their anti-depression plans were to aim at a radical abandonment of credit expansion policies. However, they reject this idea in advance. What they want is to expand credit more and more and to prevent depressions by the adoption of special ‘contra-cyclical’ measures.”

Taking up the third category: A market expert named Michael J. Panzner predicted the present financial crash more than one year before it began in a book titled *Financial Armageddon*. According to Panzner, the economy is threatened by systemic debt,

under-funded retirements and poorly understood derivatives. These factors, he warned, are likely to inspire a period of economic malaise, systemic crisis, and depression, followed by hyperinflation. His predictions are the most accurate, specific and detailed of any to date. Most interesting of all is Panzner's geopolitical concerns with regard to a financial crash. First, he notes, the United States will no longer be financially able to ensure a stable security environment for Europe, Asia or the Middle East. Free trade will be swept aside as economic nationalism takes precedence. The dollar will be called into question as the world's reserve currency, and rising nationalism will lead to bloody conflicts between former trading partners. According to Panzner, "The rise in isolationism and protectionism will bring about ever more heated arguments and dangerous confrontations over shared sources of oil, gas, and other key commodities, as well as factors of production that must, out of necessity, be acquired from less-than-friendly nations."

The Crisis Intensifies

As of this writing, in November 2008, the U.S. stock market has fallen by nearly 50 percent in 14 months. Over 2,000 U.S. banks are "in trouble," including some of the country's largest. The U.S. automobile industry is threatened with collapse. Thousands of businesses are at risk, and many are certain to fail. Manufacturers will be shut down and construction projects will be suspended. The government's futile bailout plans cannot stem the crisis or stop the deflationary cycle, and public confidence is bound to erode. Where are we headed with all this? That depends on whether the crisis remains an economic one, or becomes a political crisis leading to civil unrest or revolutionary violence.

Likelihood of Civil Crisis

The United States, like other Western countries, is not what it was. Social discipline has eroded, along with the work ethic. According to available statistics, larceny in the United States has risen around 100-fold since 1950. Divorce has approximately doubled. Illiteracy, drug addiction, out-of-wedlock births and government corruption have steadily risen. The most important factor in any crisis is the fabric of the society under stress. There is reason to suspect that prosperity now holds American society together; that without general prosperity the behavior of many would prove socially disruptive. Already there are political causes afoot in which the threat of violence is combined with abnormal psychology: the animal rights movement, radical environmentalists, and the so-called "gay movement" come immediately to mind. If these movements exist in prosperous times, what are we to expect as the financial crisis worsens?

In 1979 Christopher Lasch wrote *The Culture of Narcissism*, in which he declared that "the culture of competitive individualism ... [and] the pursuit of happiness" in the United States had been carried "to the dead end of narcissistic preoccupation with the self." He further declared that, "Strategies of narcissistic survival now present themselves as emancipation from the repressive conditions of the past, thus giving rise to a 'cultural

revolution' that reproduces the worst features of the collapsing civilization it claims to criticize."

The truth of Lasch's searing criticism was seconded in 2006 by U.C. San Diego psychology professor Jean Twenge, who gathered test data that showed a measurable increase in American narcissism from one generation to the next. Twenge's findings were published under the title, *Generation Me: Why Today's Young Americans Are More Confident, Assertive, Entitled – and More Miserable Than Ever Before*. What Twenge's data shows is an erosion of social rules, a growing emphasis on selfishness and self-absorption, unrealistic expectations about life, and epidemic anxiety in the rising generation.

The political side of narcissism may be viewed in terms of the example of the Weimar Republic, which devolved through economic crisis and political agitation into the Third Reich. Adolf Hitler is believed to have suffered from narcissistic personality disorder, and his followers were drawn into his narcissistic fantasies of omnipotence and violent revenge. Given today's economic situation, the United States may suffer the same fate as Weimar Germany. The decline of social rules is fundamental to the development of a "permissive society" which leads, in turn, to civil disorder and even dictatorship in times of stress.

According to the Austrian economist, Friedrich Hayek, the rules of extended order are vital to the development of advanced societies. Any breakdown of the rules suggests a breakdown of civilization itself, and also a breakdown of economy. Hayek asserted that dangerous revolutionary doctrines, relying on modern intellectual rationalism, threatened civilization by opposing "learnt restraints" that hold back chaotic instincts of destruction and rage (wrapped in intellectual rationalism). Cultural narcissism arguably contributes to the breakdown envisioned. The narcissistic personality is more likely to side with revolution than with the extended rules of civilized order. Immoral intellectual doctrines, noted Hayek, are carried into public education as well as government.

One symptom of malignant narcissism is envy, and revolutionary doctrines seem to derive much of their power – and their appeal – from envy. If Germany could succumb to Hitler in 1933, or Russia could succumb to Lenin in 1917, then the political crisis of today's America represents an unprecedented challenge to those who want to preserve the system. While threats from abroad may intensify as the worldwide economic crisis unfolds, a threat to civil order already exists within the United States as a consequence of widespread narcissistic attitudes. The likely sequence of events within the United States could follow earlier patterns (e.g., France in 1789, Russia in 1917, or Germany in 1933). Financial collapse, food shortages, and radical ideas are a dangerous mixture. Fueled by a "culture of narcissism" the likely outcome is revolutionary violence, social disorder and worse.

Americans should be prepared for what lies ahead. In our next paper we will discuss the likely emergence of overseas threats during a future global depression.

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Our White Paper series presents researched analyses of the current geo-political landscape. The papers suggest, among other things, that lessons embodied in the experience of earlier generations have been forgotten (or never learned) by our current crop of leaders.

These White Papers are not intended to predict the future, but rather to offer a thought process and perspective unavailable from mainstream media outlets. (Having said that, we note that, in 2006, we did predict the current financial downturn.) Our preference would be to prevent the repetition of certain parts of history, and it is to that end that we shine a light on the dangers of our nation's current path.

We hope you find our research and analysis provocative, and we encourage your feedback at: info@sovrn.com.