Ominous Lessons from Venezuela, Japan and China

January 11, 2021

by Ron Surz

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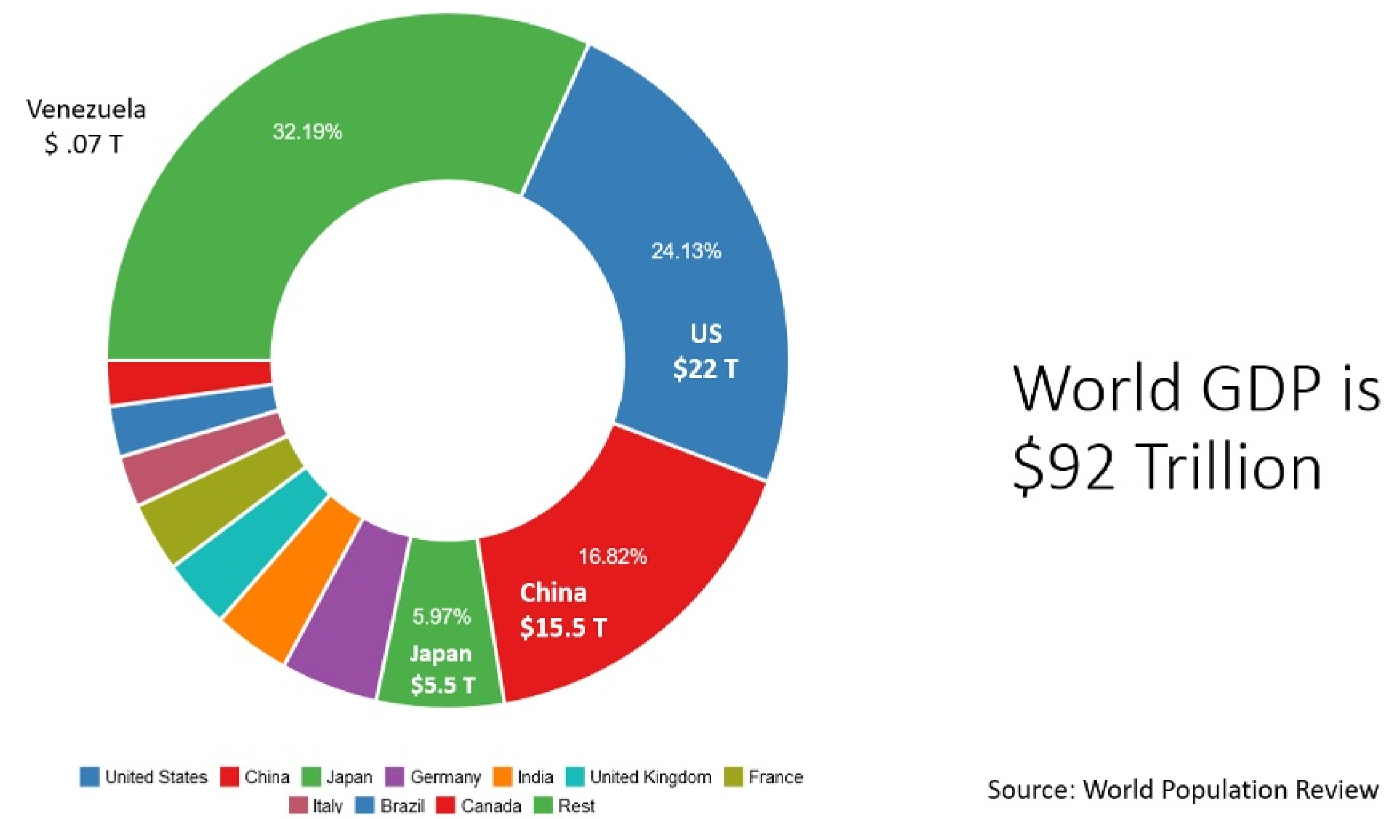
Venezuela's hyperinflation, Japan's experiment in modern monetary theory (MMT) and China's rise to global leadership carry ominous lessons for the U.S. and investors in its markets.

I will discuss the following:

- The U.S. can learn from Venezuela's mistakes that made a rich country poor while artificially inflating its stock market.
- Japan is leading the way into uncharted economic waters. The U.S. should not follow too closely.
- China is threatening the U.S. and on a path to world dominance. Conceding the throne relinquishes benefits.

My readers know that I am concerned about the U.S. economy and stock market. Money printing is slowing economic progress and will cause serious inflation, even hyperinflation. I see a U.S. stock market bubble bursting, with stock prices crashing 50% or more, likely triggered by rises in interest rates.

Some fear a repeat of the economic mistakes of Venezuela, Argentina, Greece and the like. Others cite Japan as proof that profligate spending can go on for a long time without causing inflation. And most see China as the most relevant comparison because it is striving to overtake the U.S. as the dominant economy. Lessons can be learned from those countries. I discuss these lessons in the following.



Venezuela: Riches to rags has narrowed a great wealth divide

Venezuela once was one of the richest countries due to its oil reserves, believed to be the largest in the world. The economy of Venezuela rose and fell with the price of oil, so it struggled when oil prices began dropping in the 1980s. But growth was restored and the economy leveled out, leaving poverty in its wake. Consequently, Venezuelans were unhappy with capitalism in the 1990s, so they elected Hugo Chavez as president in 1998, who launched the Bolivarian Revolution, which performed "missions" and social programs for the country. And it succeeded to lift people out of poverty. Socialism “worked” at first, but ultimately led to money printing.

Chavez’s missions had a dark underbelly. In the years that followed his election, he seized individual wealth, including land and companies, put his supporters in positions of power and gave the military broad control. Unfortunately, control of the oil industry was in incompetent hands that did not plan for cyclicality in oil prices. Consequently, money printing outstripped oil revenues through time, bringing the debt-to-GDP ratio above 240% in 2010.

In 2010, ahead of an upcoming election and as the global price of oil fell, Chávez announced he was decreasing the value of the bolivar, the nation's currency, in order to monetize the debt. The bolivar was worth more than the U.S. dollar but dropped after Chávez's decision, then continued to plummet. Hyperinflation of 130,000% ensued in 2018 and remains near 10,000% today.

In 2016, the Venezuelan stock market performed best in the world, earning 114% versus 13% on the Dow. This event has direct application to the recent U.S. stock market. According to this Marion West article:

> The curious case of the Venezuelan public equities market is a prime example of why it can be misleading to use stock markets as indicators of economic performance. Most economists agree that Venezuela’s economy is in turmoil, and that there is no end in sight. The real reason behind the market’s astronomical rise has little to do with ebullient investor sentiment, but instead is one of the symptoms of the government’s inflationary monetary policy. In short, owners of the country’s currency protected themselves from the currency’s severe devaluation by exchanging their *bolivars* for seemingly safer assets, including stocks. With huge volumes of money pouring in, the stock market artificially inflated.

The wealth divide problem was solved. Venezuela’s billionaires are penniless today. A stock market rally in 2016 demonstrated how an economic calamity can distort stock prices upward while values were falling. US investors shouldn’t be fooled by a soaring stock market in the face of a pandemic. Politicians shouldn’t take credit for an illusion; it’s laughable.

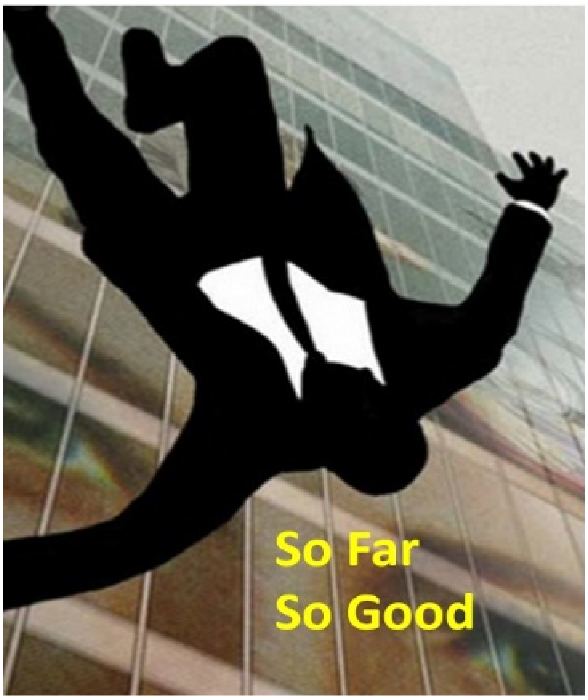
There are several lessons that can be learned:

- The great wealth divide in the U.S. needs to be addressed carefully. Socialism is not the best answer. Money printing could solve the problem by reducing the wealth of the rich through hyperinflation, an ultimate wealth tax.
- Printing money beyond the value of national resources will result in inflation and cripple the economy. The U.S. has printed $10 trillion in the past decade and more is likely. Of that, $5 trillion has been used for quantitative easing (QE) and another $5 trillion has been printed for COVID relief so far. $10 trillion is half of U.S. GDP – it's a lot.
- Stock markets can disconnect from their economies in the face of expected currency devaluation. This security price inflation creates a money illusion – stocks are not worth more.
- Being the richest is no guarantee of continuing wealth. The bigger they are, the harder they fall.

Japan: Leading the way into a frightening unknown

Japan earned its reputation as an economy adrift in the 1990s, when a popped financial bubble was followed by slow growth, deflation and low interest rates. As the government struggled to pry the economy from its rut, it pioneered policies like quantitative easing that were used around the world after the global financial crisis of 2008. Japan has led the way in implementing MMT that some, including me, believe to be the cause of a Global Debt Crisis.

MMT contends that governments can print money if they own the printing press, but to guard against inflation by raising taxes as needed. Will politicians have the political will to raise taxes? What do you think? Proponents of MMT say that politicians are the culprit because of their profligate spending, which makes sense. MMT is the "permission slip" that authorizes the spending. It's the "gun" that politicians are shooting at the economy.

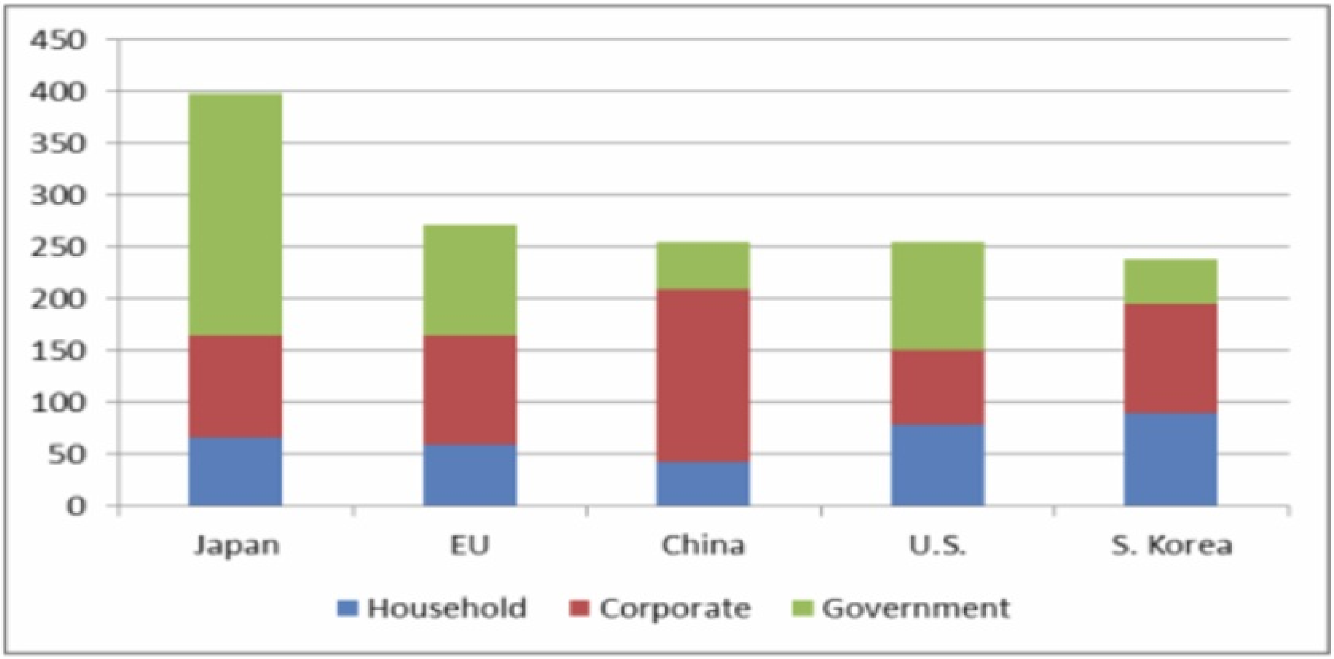


Advocates of MMT and money printing point to Japan because their economy has limped along without a serious blow-up, yet. It's like the optimist falling from the skyscraper saying "So far, so good."

As shown in the following graph, Japan's debt-to-GDP ratio of 400% is leading the world, so the belief is that the rest of the world has debt capacity. No one knows how much debt will break the bank, but most expect catastrophe when the limit is broken. Japan is poking the bear.

Figure 19. Core Debt of Nonfinancial Sectors in 2016* as a Percentage of GDI for Selected Economies

(percentage)



Source: Bank for International Settlements.

Note: * As of second quarter 2016.

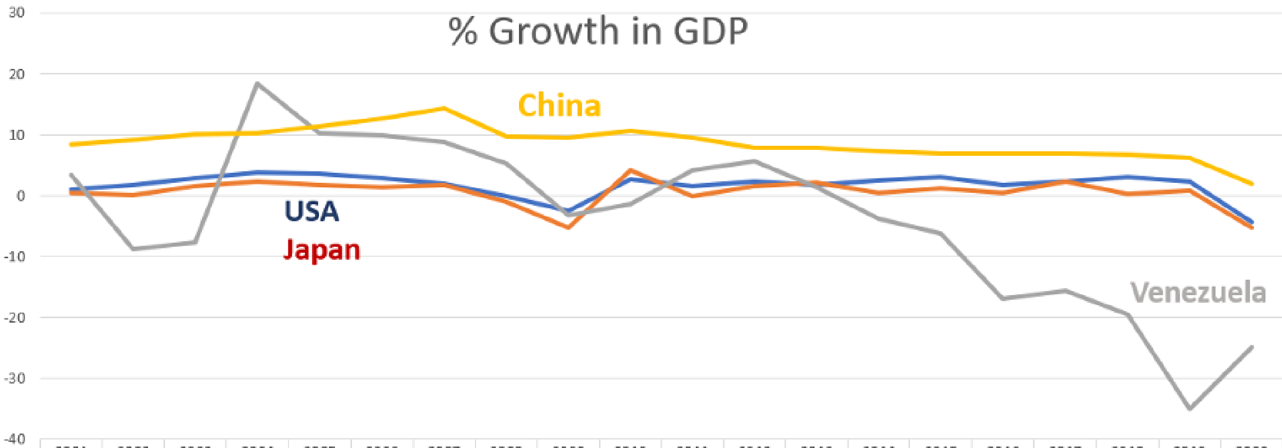
Japan is like a daredevil or kamikaze (without the suicide) pilot. I served on the advisory board of the Alaska State Pension System. On a plane that left Seattle bound for Sitka, the pilot announced that there was a blizzard in Sitka, but there was a plane 30 minutes ahead of us that was going to attempt a landing. If it landed successfully, we were going in too. He never said what we would do if that daredevil pilot did not land. Also, one safe landing does not guarantee another. The U.S. and other countries should not follow Japan too closely.

China: The prince that would be king

China is determined to become the world's largest economy, and it will probably succeed. One of the prizes will be taking over the role of the world's trading currency, perhaps with a digital yuan. Although China's nominal GDP is somewhat less than the U.S., it's purchasing power parity (PPP) GDP exceeds the U.S. It is cheaper to live in China. China's PPP GDP is $27 trillion, versus the US at $21 trillion.

Since opening up to foreign trade and investment and implementing free-market reforms in 1979, China has been among the world's fastest-growing economies, with real annual GDP growth averaging 9.5% through 2018, a pace described by the World Bank as "the fastest sustained expansion by a major economy in history." Such growth has enabled China, on average, to double its GDP every eight years and helped raise an estimated 800 million people out of poverty. China has become the world's largest economy (on a PPP basis), manufacturer, merchandise trader, and holder of foreign exchange reserves. This in turn has made China the largest U.S. merchandise trading partner, biggest source of imports, and third-largest U.S. export market.

The following graph puts economic growth into perspective. The U.S. and Japan have been slowly growing in lockstep while China has been growing 2-3 times faster.

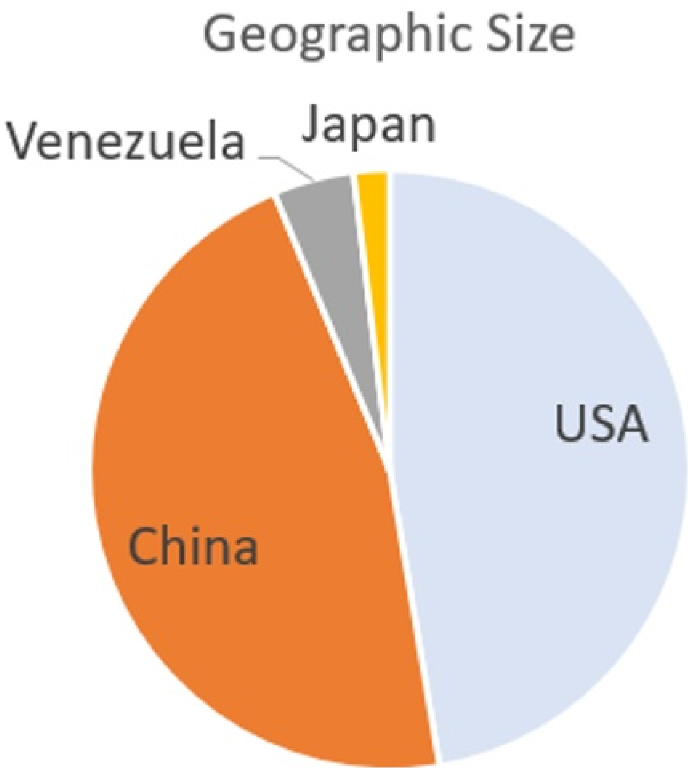


	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
USA	1	1.7	2.9	3.8	3.5	2.9	1.9	-0.1	-2.5	2.6	1.6	2.2	1.8	2.5	3.1	1.7	2.3	3	2.2	-4.3
Japan	0.4	0.1	1.5	2.2	1.7	1.4	1.7	-1.1	-5.4	4.2	-0.1	1.5	2	0.4	1.2	0.5	2.2	0.3	0.7	-5.3
Venezuela	3.4	-8.9	-7.8	18.3	10.3	9.9	8.8	5.3	-3.2	-1.5	4.2	5.6	1.3	-3.9	-6.2	-17	-15.7	-19.6	-35	-25
China	8.4	9.1	10	10.2	11.4	12.7	14.3	9.7	9.4	10.6	9.5	7.9	7.8	7.3	6.9	6.8	6.9	6.7	6.1	1.9

Source: International Monetary Fund (Graph by Target Date Solutions)

The lesson we are learning from China is that world dominance is fleeting, although as Mel Brooks said, “It’s good to be the king.” The U.S. enjoys special status that supports our currency and brings investors to our securities markets. We should enjoy it while it lasts and be prepared for new leadership as we regrettably vacate the throne.

Conclusion: Wealth preservation



The world is not perfect. We can learn from the mistakes of others. But the debt crisis is being fueled by the belief that all will be fine if we all make the same mistakes. Unfortunately, something will eventually break and most of the world will go down together. We should learn from mistakes rather than propagate them.

Webinars and podcasts on economic survival have become commonplace. They explain the tradeoffs between holding wealth in gold versus cybercurrencies. Regular paper money won’t work because it will be devalued. Treasury Inflation-Protected Securities (TIPS) might help, but the CPI measure of inflation is understated for most.

Gold and bitcoin had an exceptionally good 2020. Investors, worried about currency debasement from the money printing, sought stores of value. Gold surged over 25%, its best year in a decade, while bitcoin was up more than 300%. To be safe, gold needs to be hidden from confiscation, such as occurred in 1933 in the U.S. By contrast, cybercurrencies are easy to hide, but not so easy to understand. Like fiat (paper) money, trust is required for cybercurrencies to work, and that trust has been evolving, bringing bitcoin above $25,000 as well-known companies and investors have jumped in. The world is becoming a paperless society, so the time is right for electronic money. Be wary when a government takes control of digital currencies, as China is doing with its digital yuan.

A couple concluding quotes:

- “The difference between a politician and a statesman is that a politician thinks about the next election while the statesman thinks about the next generation.” James Freeman Clarke.
- “When will you ever learn?” chorus in Pete Seeger’s “Where Have All the Flowers Gone?”

*Ron Surz is CEO of Target Date Solutions, Age Sage and GlidePath Wealth Management, and co-host of the **Baby Boomer Investing Show** that you can binge watch on Patreon.*

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