Outlook 2015

Global Debt Deflation & Manipulated Asset Markets

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IDEA Economic Outlook 2015

Executive Summary

- The global economy is dominated by a private debt bubble that governments and mainstream economists ignore.

**Figure 1:**

*Private debt bubbles everywhere*

This debt bubble is the underlying cause of most of the world’s economic malaises—from massive unemployment in Europe to house price bubbles in England and Australia.

- The policy response has been:
  - to ignore this private debt bubble while obsessing about government debt; and
  - to manipulate asset markets via Quantitative Easing in the hope this will inflate the real economy.

- The outlook for the medium term is thus stagnation caused by private debt combined with asset market volatility. In particular:
  - America is “Turning Japanese”; and
  - China’s private-debt-financed bubble must burst in the next 2-3 years.
Is America “Turning Japanese”?

There is ample empirical evidence that private debt is a primary driver of economic outcomes. We used the level, change and acceleration of private debt to successfully predict the Great Financial Crisis. We have continued to use it to explain the current global stagnation, while the mainstream gropes with an ill-defined “secular stagnation.”

As we’ve explained elsewhere, conventional mainstream economics ignores aggregate private debt. It is not in their models, eliminated on the assumption that debt represents a “pure redistribution” between individuals which should have “no significant macroeconomic effects” (to quote Ben Bernanke). A simple look at the empirical data shows that this claim is absurd.

![Figure 2: Change in US private debt and unemployment since 1990—correlation -0.93](image)

Given this relationship, we perceive America as “Turning Japanese” after the “Great Recession”. Here’s the same chart for Japan from 1980 (ten years before its “Bubble Economy” collapsed) till today, after it has spent a quarter of a century in a state of recurring economic crisis.

![Figure 3: Change in Japanese private debt & unemployment since 1980—correlation -0.89](image)
America: Turning Japanese?

Since 1990, each tentative revival has given way to another collapse back into recession. The private debt data in Figure 3 explains why: every time a return to pre-crisis levels of economic activity has seemed to be underway, it’s been stopped in its tracks by a return to private sector deleveraging—where the rate of change of private debt is actually negative. This takes money out of the economy, and causes another recession.

Is America going to repeat this pattern?

“I Really Think So...”

There are two factors behind Japan’s pattern of brief revivals followed by a return to recession. Firstly, as Figure 4 shows, Japanese private debt got far too big during its Bubble Economy (and it peaked at a staggering 225% of GDP in 1994) and it has not fallen anywhere near enough to allow sustained growth to occur. Secondly, a total economic collapse has been averted by huge government stimulus, but every time the economy appears to recover, the government has tried to reduce its own ballooning debt. The removal of the cash flow from government spending triggers a return to deleveraging by the private sector, and the crisis returns. A “Lost Decade” has now become a “Lost Quarter Century”.

Figure 4: Gross private and government debt levels in Japan
Japan has countered each return to private sector deleveraging by more public sector borrowing. But each time the government has attempted to “balance its books” once more, the private sector’s deleveraging has recommenced, and the economy has returned to recession.

**Turning Up?**

America is now wedged between a similar rock and a hard place. Its peak level of private debt wasn’t as extreme as Japan’s (a peak of 170% of GDP, versus 225% for Japan), but just as Japan attempted to revive its economy without reducing private debt significantly, so now is America. While it will achieve short term revivals, over the long term we think America will be no more successful than Japan has been in getting out of this private debt trap.
America: Turning Japanese?

Turning Around?

This is as much a political prediction as it is an economic one. Even though America’s government response to the initial crisis was much bigger and faster than Japan’s—compare Figure 7 to Figure 5—we doubt that America would tolerate government debt levels like those Japan now has. These government debt levels haven’t had the dire effects that critics of government spending predicted, but at the same time they illustrate that a private debt crisis can’t be solved simply by increasing public debt. If deleveraging is to really occur and allow a real private sector revival, then private debt has to be substantially reduced by deliberate government policy. But there is no sign of that even being discussed in the United States—or anywhere else.

![Figure 7: Change in Private and Government Debt, US, 1990-2014](image)

Turning In?

The one outstanding example of massive private sector deleveraging was the Great Depression. Deleveraging after the Great Depression reduced the private debt to GDP ratio by 75% in total from its peak, and by 40% at a comparable time to today after the start of that crisis. This time around, deleveraging has reduced private debt by a mere 15% from its peak level—see Figure 8.

![Figure 8: Deleveraging after the Great Depression versus today](image)
But deleveraging then only occurred because of the unprecedented increase in government spending during the Second World War – see Figure 9.

**Figure 9:**
The Great Depression & World War II allowed the private sector to delever

Or Turning Down?

Without a comparable existential threat that removes any objections to massive government spending, it is likely that America will repeat the pattern of Japan. So what America faces is not “secular stagnation”, but “debt stagnation”. It doesn’t have to be this way: a sustained recovery could start if private debt levels were drastically reduced, as they were because of the Great Depression and WWII. But without such a reduction, the US economy will fail to achieve sustained growth. It is arguably more indebted now than it was at the peak of the Great Depression.

Comparing today to the Great Depression is difficult because the Federal Reserve didn’t track private debt levels back in the 1930s, and the Census Bureau used different definitions. But by producing a composite series which effectively projects the Federal Reserve definition back in time, it’s feasible that today’s recovery is beginning from a debt level that exceeds the peak reached in the Great Depression—see Figure 10. It is certainly the case that this recovery is commencing with a debt level more than 25% higher than the recovery from the recession of the 1990s.

**Figure 10:**
Combining Census and Federal Reserve data to produce a long term private debt series for the USA
Figure 11:

US Private debt is higher today than during any previous economic recovery

This scenario implies that America’s recovery will be cut short by a return to private sector deleveraging. This is especially likely if political pressure leads to attempts to rein in the government deficit. The last US long boom lasted 15 years from 1992 until 2007; we expect this one to run out of steam within 5 years.
No Wonder It’s Dark

China: End of the Bubble?

Massive demand from China for commodities and industrial inputs during the Global Financial Crisis stimulated the global economy, and made the downturn far less severe than it would have otherwise been. But China borrowed its way out of trouble back then: has it borrowed its way into trouble now? As Figure 12 shows, China’s private debt level grew explosively after the crisis began, and is now substantially higher than America’s and is still growing. It could grow further—since running a trade surplus enables a country to carry a higher level of private debt—but it must stop growing at some point. When it does, the contribution to demand from the change in debt will become negative and the rate of economic growth must plunge.

Figure 12:

*China’s private debt level grew faster than the USA’s and now substantially exceeds it*
As Figure 13 shows, the increase in private debt in China after the Global Financial Crisis began was massive: the change in debt went from 15% of GDP in 2009 to 35% of GDP in 2010.

It was also the result of a deliberate government policy to encourage private sector borrowing, and each time the borrowing has seemed to be running out of steam, the government has encouraged it to start again—with the most recent such development being the surprise cut in November.

Figure 13:
Change in debt dramatically boosted demand after the crisis

Can the Chinese government keep this bubble going? China’s trade surplus gives it more headroom than the US had to sustain ballooning private debt, but at the current rate of growth, Chinese private debt will reach Japan’s peak level by 2017—and Japan’s economic slowdown began 4 years before it reached this peak.

This implies that China will face a credit crunch within the next two years.

Its government may well react to this coming crisis more intelligently than have Western governments—and its trade surplus, massive foreign exchange reserves and political dominance over the banks gives it plenty of weapons that the USA lacked. But it will certainly have to abandon private-debt-financed growth given its current excessive levels, or else China, too, will “Turn Japanese”.

www.debtdeflation.com/blogs
Europe: The End of Austerity?

Austerity policies began in Europe in mid-2010, roughly two years after the start of the Global Financial Crisis, in the belief that Europe faced a “sovereign debt crisis”. Though these policies were supposed to be an intelligent response to an economic crisis, their impact has been to amplify the downturn begun by the Global Financial Crisis itself.

Figure 14: Unemployment at Great Depression levels in Europe

Judged by comparison to the economic outcome in the USA, these policies were a clear failure. Though America debated and talked austerity, it never actually imposed it—whereas the Maastricht Treaty gave the EU the ability to impose austerity on member states like Spain, Greece, France and Italy. The outcome is that unemployment in Europe is almost twice as high in Europe as in America—even when low-unemployment countries like Germany are included in the mix.

Judging austerity on its own terms—where the objective was to reduce the government debt to GDP ratio—it has also been a failure. The conscious attempt to reduce government debt as a percentage of GDP has led to that ratio actually rising, since the fall in GDP was far greater than the reduction in government debt.
A telling comparison here is of the USA with Spain. Before the Global Financial Crisis, Spain’s government debt was actually falling, and by 2004 its government debt level was below America’s. It was one of the few countries in Europe which fulfilled the EU’s criteria of a government debt ratio below 60% of GDP, and a government deficit of less than 3% of GDP. When the crisis began, Spain’s government debt to GDP ratio was less than three-quarters of America’s. It entered the period of austerity with its government debt ratio still more than 10 per cent of GDP lower than America’s.

Less than two years later, Spain’s government debt to GDP ratio overtook America’s—not because of profligate spending, but because the attempt to directly cut government debt resulted in a still larger fall in Spain’s GDP, so that its debt ratio rose. America, on the other hand, let its deficit reach much larger levels, and the return of economic growth meant that the government debt ratio still fell.

**Figure 15:**
European unemployment is almost twice America’s level

**Figure 16:**
US Government debt has stabilized while European debt ratios have risen
So why has austerity failed? Because the whole premise behind it—that governments should strive to run balanced budgets—is false. And it’s easy to explain why with a simple thought experiment.

Divide a country into two sectors: the private sector and the government sector (ignoring the external sector for now). Imagine that the government decides to run a surplus—so that government taxes on the private sector exceed the subsidies paid to it by the government. This means that the private sector has to run a deficit with the government. Call the difference between taxes and government subsidies NetGov. This means that the government surplus of NetGov has to be matched by a private sector deficit of exactly the same amount, as shown in Figure 17.

Where is the private sector going to get the money needed to finance the government surplus?

It could run down its existing stock of money, but that means a shrinking private sector—which is the opposite of why governments choose to run surpluses, since they believe that running a surplus is “good economic management”. So for the government to show “good economic management” while running a surplus, the private sector has to somehow produce not only enough money to finance the government surplus, but also enough to allow the economy to grow at the same time.

How can it do this?

There is only one method: the non-bank subsector has to borrow money from the bank subsector. So we need a three sector model, with the non-bank sector borrowing from the banks. Call the flow of funds from the banking sector to the non-bank sector NetLend. Then for the government to run a surplus, and for the private non-bank sector to grow at the same time, the banking sector has to run a deficit: new lending (money going out of the banking sector) has to exceed loan repayments and interest (money coming into the banking sector). That situation is shown in Figure 18.

This situation is obviously not sustainable forever. The private sector—the part of the economy that produces GDP—is growing at the rate of NetGov + NetLend, but its indebtedness to the banks is
growing at the faster rate of NetLend (since NetGov is negative). So to achieve the combination of a growing economy and a government sector surplus, the rate of growth of private sector debt has to exceed the rate of growth of the economy. In other words, running a government surplus in not “good economic management”. Instead, it is a way to set up a future economic crisis when the private sector stops borrowing.

When that does happen, NetLend becomes positive: interest payments plus repayments of loans exceed new loans. If the government insists on continuing to run a surplus in this situation, then the private sector has to go into deficit: the private sector’s money stock has to shrink, as taxes paid to the government exceed government payments, and repayment of existing debt exceeds new loans—as shown in Figure 19. The only way to balance the books with both banks and the government sector taking money out of the private sector, is for the private sector to contract—economic growth has to fall.

This is not just a hypothetical exercise: it is what austerity in Europe has achieved. Insisting on a government surplus while the private sector is reducing its debts can only work if the economy shrinks. And the economies of Spain and Greece in particular have shrunk as both government surpluses and private sector deleveraging have taken money out of the economy. In contrast, government deficits and net lending in America are injecting money into the economy, enabling it to grow (see Figure 20).
The only way that austerity can work is if the external sector—which we’ve ignored till now—is in surplus. Call the balance of payments NetExt. The banks, the government and the private sector can all run surpluses if NetExt is bigger than the government surplus and the scale of private sector deleveraging.

**Figure 21:**

The one way austerity can work — if net exports are very large

That is a big ask, and in Europe it is made all the more difficult by the Euro. If Greece or Spain had its own currency, then they could devalue and make their exports (and service industries) more competitive. But by being locked into the Euro, the only way that Spain and Greece can use price competition to increase their exports and reduce their imports is if prices in Greece and Spain fall compared to prices elsewhere—in other words, if they experience deflation.

But deflation makes the debt burden worse, and it is a policy outcome that the European Union is trying to avoid. Predictably, with the misguided policy of austerity, deflation is one outcome that the EU is actually achieving: the rate of inflation across the whole Euro area is just half a per cent and heading down, while Greece, Spain and Italy are all in negative territory (see Figure 22).

**Figure 22:**

The EU is achieving one thing it is trying to avoid: deflation

Austerity has been an economic failure and a political disaster, so it is no wonder that the Greek people seem set to reject it. If they do elect Syriza on January 25, then it may set in chain a sequence of events that leads to the abolition of the Euro. Though this would cause chaos and pain in the immediate future, it would be preferable to the permanent Depression that the EU has inflicted upon southern Europe.
Housing: Anglo bubbles diverge

One of the great myths of conventional economics is that people are hyper-rational and learn from their mistakes—so that they never repeat them. Instead, less than a decade after a crisis caused by a housing bubble, the IMF reports that there is a bubble in global house prices.

What causes house price bubbles? In a word, leverage: the more banks are willing to lend in housing finance, the higher house prices go.

Given the damage that the bursting of the Subprime Bubble did to the global economy, one might hope that governments would have done something to stop banks’ lending excessively for housing. But in fact, the opposite has happened: they’ve learnt that if you want to stimulate the economy, the easiest way to do so is to encourage a housing bubble to form.

That’s the key reason why the UK economy has superficially done so well: the “Help to Buy” scheme—which we prefer to describe as “Help to Sell”—has pumped billions of mortgage-generated money into the UK economy, driving up both the economy and house prices in the process. Since the scheme was launched (appropriately on April Fool’s Day 2013) UK house prices have been on a tear, rising 16% in just 20 months—see Figure 23.

Figure 23:

House prices bubbles widespread less than a decade after a crisis caused by a house price bubble

The link between mortgage debt and rising house prices is subtle however—subtle enough for governments and mainstream economists to miss it. It’s not the level of mortgage debt that causes the level of house prices, but the acceleration of mortgage debt that causes the change in house prices (the logic is the same as for share prices). For house prices to remain constant, the flow of
new demand for housing has to equal the flow of houses being put up for sale. The flow of new demand is overwhelmingly provided by mortgage finance, so there is a relationship between the change in mortgage debt and the level of house prices. There is therefore a relationship between the acceleration of mortgage debt and the change in house prices.

This explains the apparent paradox between Figure 23 and Figure 24: rising house prices are occurring despite household debt levels falling everywhere (except Australia). There appears to be no relationship between household debt levels and house prices.

However the relationship between the acceleration of mortgage debt and change in house prices is strong in all three countries—see the next 3 figures:

- Figure 25 implies that the rate of house price change will fall in America in 2015, and possibly turn negative.
- Figure 26 implies that the house price bubble will continue in the UK in 2015.
- Figure 27 implies that the rate of growth of house prices in Australia will fall in 2015.
America: Turning Japanese?

Figure 25:
House price change headed down in the USA. Correlation 0.86

Figure 26:
House prices headed up in the UK. Correlation 0.72

Figure 27:
House price rise tapering in Australia. Correlation 0.68
Implications for Markets

Excessive private debt levels worldwide excess themselves in economic stagnation and financial fragility. As households labour under heavy debt loads and investors continue to reach for yield. Absent a reduction in debt levels and deleveraging, which we do not see in the offing, we expect:

**Commodities to continue to deflate:** The steady decline of commodities in general -- and now precipitous decline in oil -- is a leading indicator of weak global demand. It may also indicate a speculative bubble now coming unwound. Commodity producers will be under pressure. Heavy junk bond funding in the oil patch of the US could create default risk that echoes through both the entire US high yield market and also systemically important financial institutions (Note Goldman Sachs and others have recently been cited by Congress for manipulating commodity markets. A last-minute addition to a US budget bill extended taxpayer protection to commodity derivatives).

**Official and consensus forecasts continue to err on the high side.** Eight years of continuous over-optimism ought to have led to more humility among forecasters. Rather than becoming informed by looking to those who were right in their predictions -- both on the Great Financial Crisis and the subsequent stagnation -- mainstream economists and forecasters continue to rely on their models, and continue to blame goblins in the shadows rather than revisit core assumptions or methods.

**Stress in financial markets,** as search for yield concentrates in liquid financial assets. "Investors" have been encouraged to become high conviction traders.

**Interest rates will not rise.** Whether or not the Fed raises its funds rate slightly, the interest rates on Treasuries will remain depressed. Expectations for rate increases seem way too aggressive, although the bond markets now seem to have woken up to this and unlike a year ago are realistically pricing these depreciating assets.

**Instability will increase due to low interest rates being carried to property markets and commodity producing nations.** China, Australia and the UK, in particular, are subject to apparent housing bubbles. Emerging markets and commodity producing nations bore an influx of capital and are now experiencing weakness as that capital flows out.

**Inflation will remain low in Europe and the US.** Until real incomes rise, there is no upwards demand pressure and ample downwards debt deleveraging pressure. Current deflation in real assets is masked by easy money for financial markets. Massive private debt levels bias the world towards deflation rather than inflation.

Underlying the outlook is the unwillingness or inability of the world to deal with its enormous private debt burden. Prospects for write-downs or for public borrowing and spending that would reduce the relative size of the private debt through growth or inflation are dim. A change in fiscal and monetary policies, even after more than five years of ineffectiveness, is not likely. The growing inequality in many nations – the result of stagnant incomes at the low end and artificially supported asset prices at the top – is already fuelling discontent. How that political and social aspect plays out is not amenable to forecasting. Although there remains short-term growth potential within the USA, the baseline is an economy bouncing along the bottom with downside risks—though benefiting from a revival of private debt financed demand in the immediate future.
Professor Steve Keen is the Chief Economist at the Institute for Dynamic Economic Analysis (IDEA) and the Head of the School, Economics, History and Politics, Kingston University London, with the mandate to form the first truly heterodox economics department in Europe. Steve was cited as the economist who best predicted the Great Financial Crisis and the Great Recession. He was among a remarkably small number who foresaw the crisis and raised the alarm in advance of the largest economic event of the post-Depression era.

Steve authored the book *Debunking Economics*, a tour de force on economic history, theory and practice, as well as the influential *Debtwatch* website and dozens of scholarly papers. His work develops the insights of financial Keynesian economist Hyman Minsky with mathematical modeling of Minsky’s Financial Instability Hypothesis. He is internationally known, recipient of the award for the economist who best predicted the 2007 financial crash and the ensuing global financial crisis, respected by both professional and lay observers.

IDEAeconomics (Institute for Dynamic Economic Analysis) is a think tank dedicated to raising awareness of the importance of private debt in economics, and to the reform of economic theory and policy.

To follow up on this paper please contact Alan Harvey, the Director of IDEA economics: harvey@ideaeconomics.org.

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