

Economic Update, July 2015

The Effects of Over-Indebtedness

By Richard Morey

The world economy certainly *should* look confusing to anyone paying attention. This is actually by design, as our political and financial leaders have worked very hard to make it difficult to understand what is going on in the world economy. For example, around two years ago the head of the European Central Bank, Mario Draghi, crowed that Greece was fixed and on the road to prosperity while all those who had bet against the Greek economy had been proven wrong. The fact he said this while Greece remained in a depression (not a recession, but a bona fide depression) should have told us he was lying, while recent developments in Greece have proven this point. Here in the United States, every year the Fed and other leaders assure us this coming year is the one in which our economy will finally reach their elusive “escape velocity,” only to be proven wrong each and every year. Then we have China – the great “black box” of the world economy in which it is basically impossible to know what to believe. According to their authorities, their economy has now slowed down to its lowest growth rate since 2009, expanding at “only” 7% in the first quarter of this year. At the same time, objective Chinese experts say growth was somewhere between a negative 2% and a positive 4-5%.

Given the above, is there a way to make sense of it all? Fortunately, the answer is yes, as exactly one key fact is determining economic performance. This fact is the huge dog wagging the tail of the world economy, and it is called debt. We had a debt crisis in 2008-2009, i.e. too much debt and too much bad debt. Since that time, total debt in the world has exploded higher, growing by some estimates 40% since 2008. You simply cannot follow this path and get out alive – or without having another financial crisis.

As I have shared many times in the past, large-scale historical studies have shown that when a nation becomes over-indebted, their economic growth slows to an average of 1% a year until that imbalance is corrected. In addition, they tend to have much more frequent recessions. And indeed, economic growth in the developed world (the U.S., Europe, Japan and China) has been approximately half what it once was since we exited the Great Recession in 2009. Europe and Japan have also had the expected more frequent recessions, while China may now be in their first recession in many, many years.

Here in the U.S. we have had the slow growth without another recession. The Economic Cycle Research Institute recently put out a note entitled *Simple Math: $\frac{1}{2}\% + \frac{1}{2}\% = 1\%$* . In this article they explained that overall economic growth or GDP can be accurately calculated by adding the growth in the total number of hours worked in the country to the growth in productivity per worker. On the productivity front, they state: “For the past four years, productivity growth has averaged *just over $\frac{1}{2}\%$ per year*, leading Fed Vice Chairman Stanley Fischer to lament that it “has stayed way, way down.” Given the latest data, one could say that the U.S. is in a “productivity recession,” having seen the largest back-to-back quarterly productivity *declines* in 22 years.” Regarding the hours worked in the U.S., they say “...the Congressional Budget Office says it (total hours worked) will stay at *$\frac{1}{2}\%$ per year* at least for the next decade. This is pretty much set in stone, given the demographics.” (From www.businesscycle.com, June 11, 2015.) The employment picture looks much worse from a longer-term perspective. I was shocked to see the total number of hours worked in this country last quarter was only 1% higher than it was in the spring of the year 2000. In the last 15 years we have added millions and millions of new should-be workers with nearly no new hours being worked. Combining the growth in productivity with hours worked, we get a maximum potential mid to long-term growth rate of 1% in our country, which is approximately one-third the rate we had for decades before 2000.

Both low productivity and the low number of hours worked are related to the hollowing out of our middle class. The average new job is part-time, paying close to minimum wage. Yes, managerial level workers (and those in the energy industry until recently) have been doing quite well, but the remaining 80+% of the workers in this country have seen their real income drop by approximately 10% since 2000. We now have 1.7 million fewer “breadwinner” jobs, i.e. jobs paying middle-class wages, than we did in December of 2007 and fewer middle-class jobs than we had 15 years ago. Lower-level jobs cannot lead to increased

productivity (think of how a computer science employee may be involved in an activity that will increase the work thousands and thousands of other workers can accomplish while it is basically impossible for waiters to substantially increase how much food they can deliver to tables in a shift). And obviously part-time workers don't work as many hours as full-time.

How does this relate to debt? The decline of the middle class has actually been going on for well over 15 years, but for most of those years households were able to get around their lack of income growth by borrowing to maintain their standard of living. With approximately 70% of our economy dependent on consumer spending, the Fed has thought we absolutely have needed consumers to go deeper and deeper into debt to spend ever-more of the income they aren't earning! The last gasp of this was the housing bubble in which average people were using their home equity as an ATM machine to withdraw cash. That ended in 2008, and since then our consumers have remained over-indebted but either unable or unwilling to add dramatically to their debt loads. Our citizens have basically reached the maximum debt level they can have and still survive the monthly payments.

Our government stepped in to the rescue, adding trillions and trillions of new debt since 2010 to try to keep the spending going. But this led to a rather large backlash against our politicians, so they turned the job of saving us completely over to the Fed. The Fed pegged interest rates at zero to try to get more debt created. This was, however, a huge failure. As mentioned above, average consumers cannot take on more debt. And although the short-term rate the Fed controls has been at 0%, these poor consumers get most of their debt from credit cards charging 20% or more in interest! The business community as a whole has also not been too interested in more debt – at least debt to expand their businesses. Instead, corporate America has only borrowed heavily to buy back their own stock or to buy each other, actions that do nothing for the economy.

Against this bleak backdrop, the Fed decided to print around \$4 trillion of fresh money. Maybe if the banks had a few trillion dollars extra lying around some of it might get loaned out. They were correct. A few trillion was loaned to companies in emerging markets, as their growth prospects looked better than ours. And as mentioned above, a few trillion was borrowed by our corporations to buy back stock or to buy each other (leading almost always to job losses). However, the one place this money did not go towards was business expansion in the United States.

History will show our Federal Reserve Board (and other central banks around the world) made perhaps the largest mistakes ever in monetary policy during this time period. You don't have to take my word for this. Just look at some excerpts from the Bank of International Settlement's (the 'Bank of the World's Central Banks') annual report published last week:

"Policies have been unable to constrain the build-up and collapse of damaging financial booms, ie the global economy exhibits "excess financial elasticity" – think of an elastic band that can be stretched out further and further until, eventually, it snaps back more painfully...

If one acknowledges that low interest rates contributed to the financial boom whose collapse caused the crisis, and that both the boom and the subsequent crisis caused long-lasting damage to output, employment and productivity growth, it is hard to argue that rates were at their equilibrium level. This also means that interest rates are low today, at least in part, because they were too low in the past. Low rates beget still lower rates. In this sense, low rates are self-validating. Given signs of the build-up of financial imbalances in several parts of the world, there is a troubling element of déjà vu in all this...

What to do now? **Room for maneuver in macroeconomic policy has been narrowing with every passing year. In some jurisdictions, monetary policy is already testing its outer limits, to the point of stretching the boundaries of the unthinkable.** In others, policy rates are still coming down. Fiscal policy, after the post-crisis expansion, has been throttled back, as sustainability concerns have mounted. And fiscal positions are deteriorating in emerging market where growth is slowing. What, then, should be done now, besides redoubling reform efforts to strengthen productivity growth?

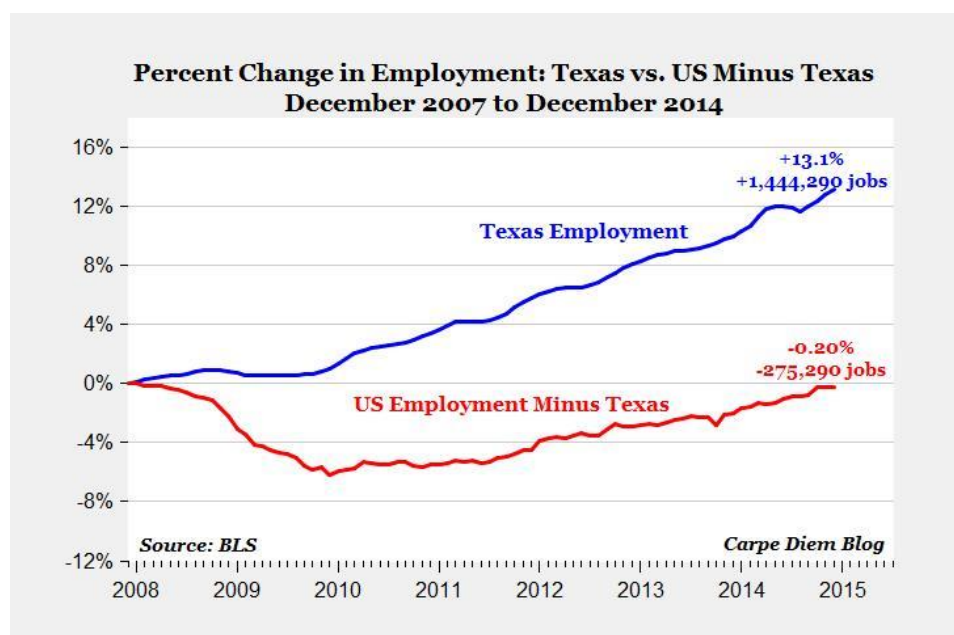
For monetary policy, there is a need to fully appreciate the risks to financial and hence macroeconomic stability associated with current policies...

Given where we are, normalization is bound to be bumpy. **Risk-taking in financial markets has gone on for too long. And the illusion that markets will remain liquid under stress has been too pervasive. But the likelihood of turbulence will increase further if current extraordinary conditions are spun out. The more one stretches an elastic band, the more violently it snaps back.** Restoring more normal conditions will also be essential for facing the next recession, which will no doubt materialize at some point. **Of what use is a gun with no bullets left?"**

Here is the summary of their report from one insightful analyst (an anonymous Wall Street insider): “As you can see, the BIS is now pounding the table on the irresponsible actions of the bank's own board members. The celebrated monetary policy "bazooka" is out of ammunition even as the imbalances, excesses, and outright speculative bubbles post-crisis central bank policy has helped to create appear set to boil over. That is, the "rubber band" — to use the BIS' analogy — has been stretched farther than ever before and now threatens to snap back violently...

In sum, central banks have sown the seeds of their own destruction by failing to acknowledge their limitations, setting the stage for a tragically absurd endgame wherein central bankers suddenly realize that bringing every tool in the monetary tool box to bear on financial markets has created the conditions for a collapse which they will be unable to arrest precisely because any and all emergency measures were exhausted in the frantic attempt to reflate the last centrally planned bubble.”

The question remains as to why the United States has not yet had another recession? It may have been due to just enough of the money the Fed printed having leaked into the economy; perhaps just enough money was borrowed at low interest rates and spent to keep our economy's head above water. Or more likely the explosion of our oil and gas industry in recent years was the sole reason we haven't had another recession. The chart below shows the total change in employment in the U.S. since 2008, with and without Texas whose economy benefited greatly from the oil and gas boom:



However, due to oil prices being down 40% employment growth in Texas has now come to an end.

If second quarter GDP came out today it would likely show our economy expanded at just under 1% in the first half of the year, or one-third its long-term performance. Of course we will have another recession, and

since they are never detected until at least nine months after they begin, for all we know we entered the next recession months ago. You can certainly find evidence suggesting this. Manufacturing, for example, has now fallen 8% year over year – something that has never occurred outside a recession. Exports have also dropped precipitously, along with all global trade. At the same time, an optimist can still find some positive economic news. It does, however, usually require some mental gymnastics to view the positive data very positively when put into the proper context. Employment is the perfect example. The economy added over 230,000 new jobs in the recent monthly report, but over 600,000 more workers dropped out of the workforce. So while we cannot say if the U.S. economy is now going down or up, we can say with near certainty it is not getting ready to “take off” as I hear stated in the financial media several times each day.

Earlier I wrote: “You simply cannot follow this path and get out alive – or without having another financial crisis.” The world economy has too much debt, and too much of this debt is “bad,” i.e. will never be repaid. This will lead to massive losses in a financial world in which the banking systems are interconnected in both obvious and unseen ways nearly guaranteed to bring down the entire structure whenever one piece falls.

Which piece will fall first? I have no idea, as the possibilities are too numerous to catalog. It could be Greece, though I personally believe this is unlikely. The Greek saga is a human tragedy, as their middle class no longer exists, replaced entirely with desperately poor people. But I have expected they will once again “kick the can down the road,” meaning they will make a few meaningless changes to essentially retain the status quo. The status quo means they remain in a depression. They should leave the Eurozone and restart their nation independently, charting a prudent financial course. Unfortunately, their citizens are afraid to do this because they trust themselves even less than they trust their “partners” in the Eurozone who are actively trying to hurt them. Tragic.

Logically one might expect China’s economic and market problems to be the catalyst for the next round of economic calamity. Greece has \$350 billion of debt, much of which they will never be able to repay. China probably has close to \$10 trillion of bad debt, having gone on the greatest borrowing and spending/wasting binge in economic history. The fact their citizens’ attention was diverted from their falling real estate prices to a soaring stock market, only to now have their stocks drop into a bear market in less than three weeks, highlights how volatile their situation is right now.

Or the dominoes on the world economy could come tumbling down based on little Puerto Rico’s \$72 billion of municipal bond debt. Since they are now essentially declaring bankruptcy, this may bankrupt the large municipal bond insurers. This could topple several other financial institutions in the United States, which could then pull down several major European banks – most of which remain practically insolvent to this day. Then stock markets simultaneously crash, and the world enters a recession much more serious than the one in 2008-2009. Now I have no way to know if Puerto Rico’s insurers are connected to other financial institutions such that they could pull down the financial system. I do know we have much, much more bad debt today in the world than in 2008, the consequences of which are likely to be commensurately more severe. And financial institutions around the world are even more intertwined – and larger – today than in 2008. So we know for sure the ingredients for financial crisis are present, in larger amounts, than in 2008, but who knows which single piece of falling bad debt may bring down the financial world this time around?

On the other hand, perhaps we won’t have another financial crisis but will instead see the world and U.S. economy struggle along at a low and diminishing growth rate for the foreseeable future. I doubt this, but it’s possible. Either way, at some point we all must face the fact economic policies focused solely on creating more debt, and monetary policies focused on grand money-printing experiments designed to inflate asset bubbles at the expense of main street and average workers, are the precise wrong paths to take. Instead, we need to focus on ways to increase good jobs – specifically the number of hours worked, the wage level of those jobs, and productivity – **while reducing overall debt.**