Rudd's essay is on the money

Published in July 27th, 2009

Posted by Cassander in Australia, Debtwatch, Great Depression, RBA

56 Comments

Australian Prime Minister Kevin Rudd has followed up his critique of neoliberalism with a new essay in the Sydney Morning Herald on the causes of the crisis, and the policies needed after recovery.

With one exception, his key explanations for the crisis are the same as those identified by myself and the handful of other economists who predicted this crisis before it happened:

The roots of the crisis lie in the preceding decade of excess. In it the world enjoyed an extraordinary boom… However, as we later learnt, the global boom was built in large part on a three-layered house of cards.

First, in many Western countries the boom was created on a pile of debt held by consumers, corporations and some governments. As the global financier George Soros put it: "For 25 years [the West] has been consuming more than we have been producing — living beyond our means."

In the United States, in particular, consumers went on a long, debt-fuelled shopping spree. Household debt rose from about 65 per cent of income in 1983 to nearly 140 per cent of income by 2007. The commentator Bill Gross summarised the US consumption boom as: "For too long it's been McHouses, McHummers and McFlatscreens, all financed with excessive amounts of McCredit — What a colossal McStake."

Australian consumers also spent up big. Between 1996 and 2007 there was a 460 per cent increase in credit card debt, a 340 per cent increase in household debt, a 450 per cent increase in corporate debt and a 200 per cent increase in net foreign debt.

Second, these debts were racked up on the back of skyrocketing asset prices. In several countries, stock prices and house values soared far above their true long-term worth, creating paper wealth that millions of households used as collateral for their growing debts. The value of global financial assets grew from less than 45 per cent of global GDP in 2003 to nearly 490 per cent in 2007. Of course, this bubble was fed by a regulatory system that encouraged excessive greed. Weak financial regulation allowed corporate cowboys to take on dangerous financial risks that began to threaten the financial system itself…

The finance sector, rather than servicing the needs of the real economy, began to primarily service itself.

The final layer of the house of cards was the huge volume of money funnelled from China, Japan and the Middle East to Western banks and governments. Cheap savings from the East flooded into the West to finance ballooning deficits. From 1999 to 2006 the US current account deficit more than tripled, from $US63.3 billion to $US214.8 billion, balanced by huge surpluses in other countries, especially China.

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The only element of that with which I disagree is the third point–which I’ll get back to later on.

Rudd also provides some interesting “insider’s” statistics on the size of the collective efforts taken by OECD governments to try to limit the scale of the crisis:

On the fiscal front, governments from the world’s largest 20 economies are expected to collectively pump about $US5 trillion into their economies by the end of next year (or nearly 8 per cent of global GDP since the crisis began). Altogether, the measures are the equivalent of an extraordinary and unprecedented 18 per cent of global GDP.

That’s an extraordinary injection–against which the scale of this crisis should be apparent. Inject an additional 18 per cent of activity into a global economic system over about 3 years, and yet the system still falls by about 6 per cent over that period? Without that intervention, output could have fallen by 25 per cent over 3 years, which is a Depression in anyone’s language.

Where I differ again with the Prime Minister is over whether this government stimulus alone is sufficient to avoid a Depression. Though his case is far more nuanced than most, the “green shoots” phrase nonetheless gets an airing:

We have already begun to see the results. Early signs of “green shoots” have emerged in recent economic data. And this month the International Monetary Fund revised up its forecast for the global recovery, from 1.9 per cent to 2.5 per cent growth next year. An IMF report this month noted “the world economy is stabilising, helped by unprecedented macro-economic and financial policy support". The truth, however, is the world is still a long way from recovery.

The extent to which Rudd is "levelling" with his audience is also quite welcome:

The average budget deficit for OECD economies increased more than sixfold, from 1.4 per cent of GDP before the crisis in 2007 to 8.8 per cent of GDP in 2010. Public borrowing is required to finance these deficits and is expected to increase from 73.5 per cent of GDP in 2007 to 100.2 per cent in 2010. Among the big advanced economies, net debt will increase from 52 per cent of GDP in 2007 to 79 per cent in 2010.

Australia's deficit and debt position have inevitably been affected, albeit much less than in other advanced economies. The combined effects of collapses in revenue ($210 billion) and policy interventions to support our economy ($77 billion) are expected to result in a deficit that peaks at 4.9 per cent of GDP in 2009-10. Net public debt is expected to rise to 4.6 per cent of GDP this financial year and peak at 13.8 per cent of GDP in 2013-14. Both are the lowest by an order of magnitude of all major advanced economies.

Clearly, government global action has come at a cost. But as the IMF argued earlier this year: "While the fiscal cost for some countries will be large in the short run, the alternative of providing no fiscal stimulus or financial sector support would be extremely costly in terms of the lost output."

Without government intervention, global growth, global unemployment and prospects of global financial recovery would be much, much worse.

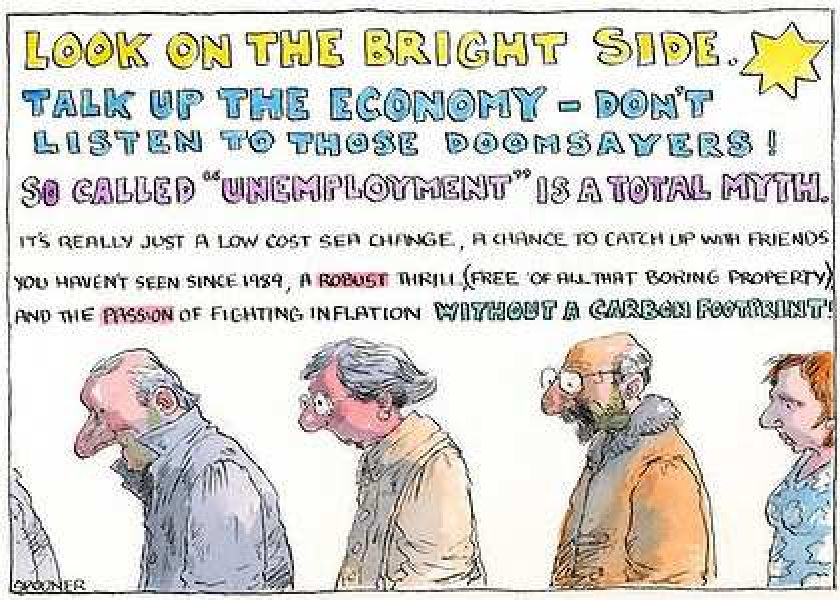
We never got to see whether Howard or Costello would have provided a reasoned explanation of policies in the light of an economic catastrophe, because they never experienced one–instead, they were amongst the lucky incumbents who held office while the global financial excess that caused this crisis held aloft the illusion of prosperity, and lost office before The Piper called to collect on The Tune.

Had they held on to power, I have no doubt that they would have–by force of necessity–been undertaking very similar fiscal policies to those Rudd now is (though the additional expenditure may have gone on the military and border patrols rather than ports and schools). Whether they would have presented as reasoned an explanation for their actions I think would have been less likely.

Rudd also revisits the anti-neoliberalism theme of his previous essay:

As I have argued elsewhere, the boom-and-bust economic cycle of the past decade has been an unavoidable consequence of a decade of neo-liberal free market fundamentalism that reinforced a culture of corporate greed and excess in the financial sector. The central principles of this extreme form of capitalism are that markets are self-regulating; that government should get out of the road of the market altogether and that the state itself should retreat to its core historical function of security at home and abroad.

As someone who has long argued that the economic theory that underlies neoliberalism (Neoclassical Economics) is intellectual drivel, I of course support this critique.



Where I beg to differ is Rudd's dating of this–merely the last decade? We've been following Neoclassical-Economics-inspired policies ever since 1975, including under the preceding Australian Labor Party government of Bob Hawke and Paul Keating (or since 1973 if we include Whitlam's 25% overnight cut in tariffs). And of course, the last decade wasn't one of boom and bust around the globe, which was partly the problem: the mild US downturn after the 2000 Stock Market Crash occurred because the huge runup of private debt-financed spending that was the Subprime Crisis overwhelmed the negatives of the DotCom swindle, and of course set us up for the far bigger crash we are now experiencing.

The absence of economic downturns since 1993–and the mildness of the mainly US recession after the DotCom Bubble burst–played a large role into deluding neoclasssical economists like Bernanke into believing that they had tamed the trade cycle in what they termed "The Great Moderation":

… the low-inflation era of the past two decades has seen not only significant improvements in economic growth and productivity but also a marked reduction in economic volatility…, a phenomenon that has been dubbed "the Great Moderation." Recessions have become less frequent and milder, and … volatility in output and employment has declined significantly… The sources of the Great Moderation remain somewhat controversial, but … there is evidence for the view that improved control of inflation has contributed in important measure to this welcome change in the economy … (Bernanke, 2004)

Bollocks to all that. The prediction I made in 1995 in my paper "Finance and Economic Breakdown: Modelling Minsky's Financial Instability Hypothesis" has stood the test of time rather better:

From the perspective of economic theory and policy, this vision of a capitalist economy with finance requires us to go beyond that habit of mind which Keynes described so well, the excessive reliance on the (stable) recent past as a guide to the future. The chaotic dynamics explored in this paper should warn us against accepting a period of relative tranquility in a capitalist economy as anything other than a lull before the storm. (Keen, 1995)

A Nascent Recovery?

Like most global leaders, Rudd is now speaking as if recovery has already begun. But to give him his due, even here there is a word of caution:

The first phase of Australia's response to the global crisis has legitimately focused on crisis management, emergency interventions and implementing a strategy for recovery. But we must now deal with two challenges that arise in the context of a possible recovery.

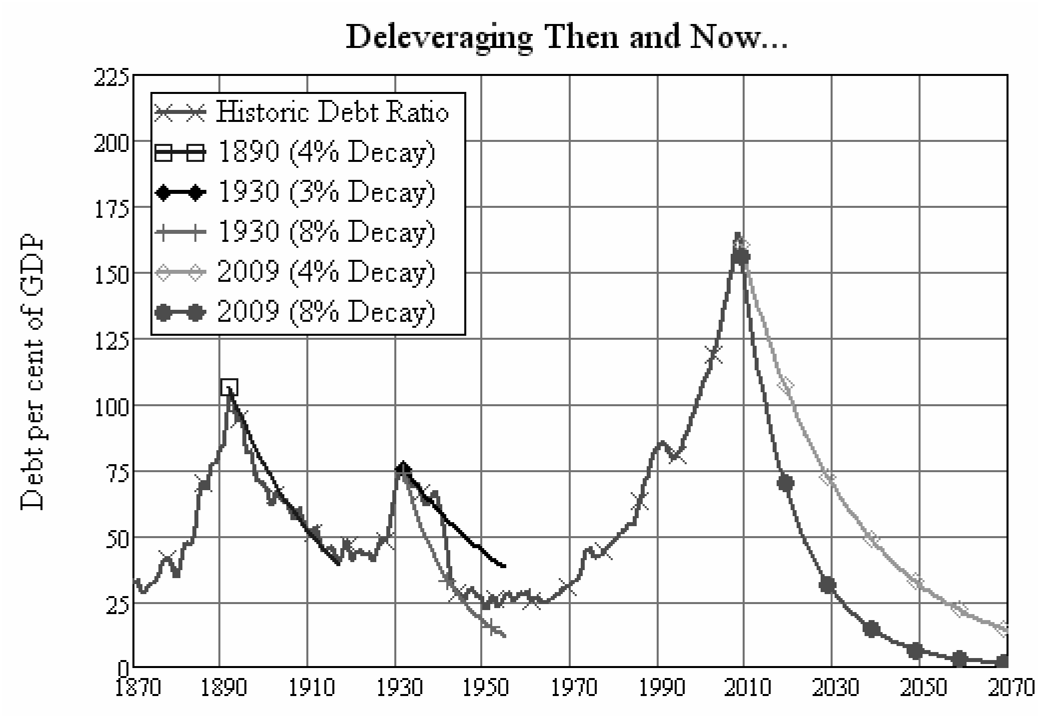
There is also welcome realism that a debt-financed recovery is barely possible and certainly undesirable, and an awareness that deleveraging and deflation are the major risks facing the global economy.

This crisis has shown we have reached the limits of a purely debt-fuelled global growth strategy. Not only will the neo-liberal model of the past not provide growth for the future, its after-effects will make recovery more difficult. Mountains of global public and private debt, global imbalances, and a weakened global financial system will drag on global growth for a long time. As the renowned financial columnist Martin Wolf has written: "Those who expect a swift return to the business-as-usual of 2006 are fantasists. A slow and difficult recovery, dominated by de-leveraging and deflationary risks, is the most likely prospect."

Since Rudd has properly entertained the prospect that the next decade will be dominated by deleveraging rather than rising debt levels, let's get a handle on what that might mean for aggregate demand over that decade.

Australia has experienced two previous bouts of deleveraging, in the Depressions of the 1890s and 1930s. In both those previous Depressions, deflation and falling real output drove the debt to GDP ratio higher after the onset of the crisis–something we have yet to experience–after which the painful process of deleveraging began.

In the 1890s, we began with a debt to GDP ratio of just over 100 per cent, which then fell to a low of roughly 40 per cent over a 15 year period. In the 1930s, we started with a lower level of 75 per cent, which fell over a similar period to a low of 25 per cent–but the Second World War clearly accelerated the deleveraging process, which prior to then was running more slowly than after the 1890s Depression.



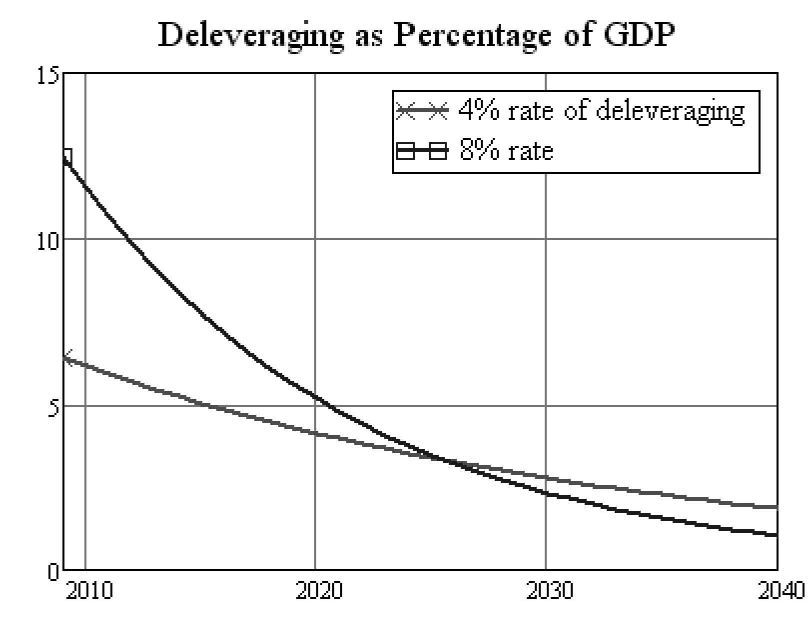
In the Figure above, these historical episodes are fitted by an exponential decay process. The rate of decay in the 1890s was roughly 4% per year; it began at roughly 3% in the 1930s prior to the War, but over the entire period including the War it fell at an average rate of 8% a year.

There was no policy intervention to accelerate economic recovery in the 1890s, so 4% might be taken to be the endogenous capacity of a Depressed economy to de-lever, whereas 8% can be regarded as a policy-accelerated rate (where however that "policy" was an arms race during a global military conflict). Both these rates are considered as hypotheticals for reduction of our debt levels today.

Taking 50% of GDP as a level at which normal economic activity might resume (higher than the 40% level that applied in the 1920s and 25% level of the 40s-60s), this implies that deleveraging could take anywhere between 15 years (at the accelerated 8% rate) and 30 years (at the "natural maximum" 4% rate).

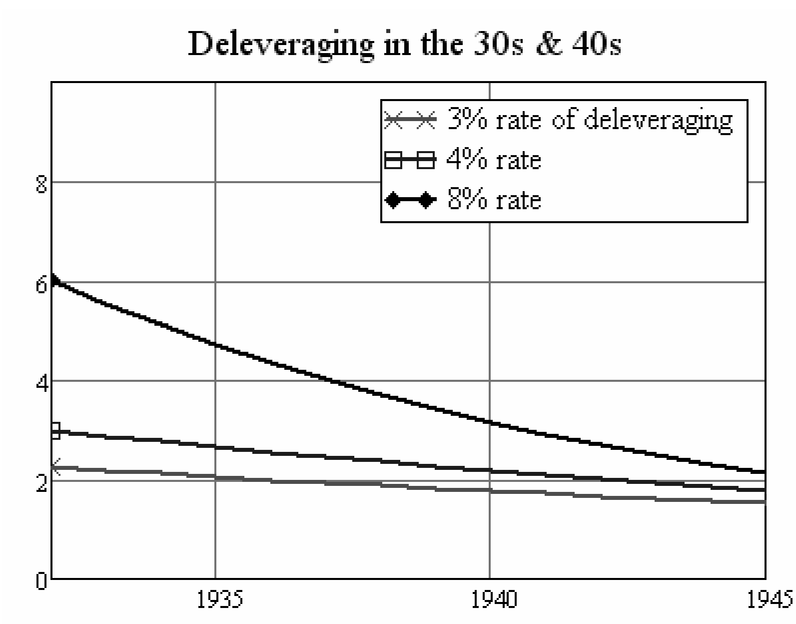
We can get a preliminary handle on what this might mean for economic growth by calculating the percentage of GDP represented by each year's deleveraging–effectively by converting the percentage reduction in debt each year into a fraction of GDP for that same year (this ignores feedbacks between the rate of change of debt and GDP itself, but it will do as a first pass). In the first year (2009) when debt started at 165% of GDP, a 4% reduction in debt levels is equivalent to a 6% reduction in GDP; the size of this hit then falls as the debt to GDP ratio itself falls.

The following chart shows each year's deleveraging as a percentage of GDP, at the rates of 4% and 8% per year:



We are currently deleveraging at the 4% rate, and debt has fallen from 165% of GDP in March 2008 to 159% today–a 6% fall as a percentage of GDP, as noted above. At this rate, debt will not fall below 50% of GDP until 2038, and the annual reduction in debt will be equivalent to 3% of GDP until 2028.

To compare this to what happened during the 30s and 40s, the next Figure shows the impact of deleveraging in the 1930s: the actual 3% rate that applied from 1932 till 1939, what a "natural maximum" rate of a 4% fall per year would have meant as a percentage of GDP, and how bad things might have been without a World War if the achieved rate for 1932-45 of an 8% reduction had come via reducing debt rather than increasing GDP via a huge militarisation effort.



Even the worst rate of 1930s deleveraging (including WWII) only just compares to the impact of deleveraging today at the 4% rate–because the debt ratio in 2008 peaked at 2.2 times the peak level in the 1930s. And throughout the 1930s, deleveraging never subtracted more than 3% from GDP–again because debt was so much lower then than it is now.

While Rudd is therefore aware that deleveraging will probably be the defining economic experience of the next decade, I doubt that he is aware of the scale of its potential impact. Though Treasury–if it has had any input into Rudd's paper–seems more aware of the dangers of deleveraging than the RBA, deleveraging is surely not factored into Treasury's economic modelling of the post-crisis recovery scenarios on which some of Rudd's budget predictions are based. These presume a return to real economic growth of 3%+ by 2010, which imply a capacity for the economy to grow at upwards of 7% per annum in real terms, to counteract deleveraging subtracting more than 5% from GDP every year till 2015.

If we rely upon the "natural maximum" process of deleveraging, we face a 30 year period in which changes in debt will cut at least 3% from the growth potential of the economy

This is why I propose a far more radical policy to deal with the crisis than the government stimulus package that Australia and other OECD nations have followed to date. These policies are attempting to address a crisis caused by irresponsible private lending, yet they involve continuing to respect this debt. They attempt to counteract private deleveraging by running up public debt instead. And they drastically underestimate the impact of deleveraging: rather than achieving a return to growth by 2010, these policies alone are likely to result in zero or sub-zero growth for most of the next decade.

That private debt does not deserve respect. It was irresponsibly lent in the first place, and the financial institutions that lent it should pay the price–not the public nor the public purse–via deliberate debt reduction. This of course would bankrupt those financial institutions, but as should be obvious from the US experience, these institutions are effectively bankrupt already.

A Copernican Switch on Savings

I noted above that the one aspect of Rudd's analysis of the crisis that I disagreed with was the proposition that:

The final layer of the house of cards was the huge volume of money funnelled from China, Japan and the Middle East to Western banks and governments. Cheap savings from the East flooded into the West to finance ballooning deficits.

This is the "Savings cause Loans" perspective of the conventional model of money. As I explained in The Roving Cavaliers of Credit, this model is rather like the pre-Copernican view that the Sun orbits the Earth: it's easy to understand (we still speak of "sunrise" and "sunset" after all) and also completely wrong. Just as the Earth orbits the Sun, "Loans cause Savings".

The "excess savings" of the East were thus caused by the excess borrowing of the West. Chinese, Japanese and Middle Eastern accounts accumulated money because Western consumers and firms borrowed up big, and spent that borrowed money buying goods produced in China, Japan and the Middle East. Now that the borrowing binge in the West has come to an end, those "excess savings" in the East should start to diminish.

Conclusion

Rudd's essay shows a stronger appreciation of the causes of this crisis, and the fragility of the economy in its wake, than I've yet seen from any other official source (with the sole exception of the Bank of International Settlements, where Bill White's influence appears to remain, even though he is no longer its Economic Adviser–check this story on Bill and his forlorn attempts to raise the alarm during the Bubble).

Its one weakness is continued reliance upon neoclassical economic models to predict the future course of the economy after this crisis–when those same models ignore the role of private debt (which caused the bubble in the first place) and deleveraging (which will in fact drive the future course of the economy).

We can expect Rudd and Swann to continue with a large scale fiscal stimulus, in the hope that this will end the crisis. The next stage will come when this stimulus fails to achieve the level of growth predicted by neoclassical economic models, and as a result unemployment exceeds forecasts, public debt continues to run up, and deficit reduction strategies get pushed back in time.

So though Rudd is aware of the problem of deleveraging, he hasn't yet taken developed policies that directly tackle it. But awareness of the problem is a necessary first step in addressing it, and Rudd has taken that first step.