

The global economy: stuck in the debt overhang.

Adair Turner , March 4th 2015

I have been asked to make some comments on the UK situation, including on the political risks now emerging, with the possibility of a referendum on the U.K.'s membership of the European Union. But the U.K.'s current economic prospects and political developments can only be understood within the context of global and European developments. So I will present my perspective on that context before zeroing in on the UK situation.

Seven years after 2008, markets, many commentators and some policymakers, have failed to grasp how deep are the deflationary headwinds facing the global economy as a result of the debt overhang left behind by decades of excessive private sector credit growth.

The most fundamental cause of the 2007 to 8 financial crisis, and in particular of weak post-crisis recovery, is summed up on Exhibit 1 – which shows private sector credit in advanced economies growing from 50% of GDP in 1950 to 170% in 2007, and with the vast majority of this growth, as Exhibit 2 shows, extended to finance real estate.

This credit growth drove asset price increases, and in particular real estate price increases, in the self reinforcing cycle described by economists such as Hyman Minsky (Exhibit 3) . In 2007/8 we then faced a “Minsky moment”, a break in confidence which drove asset price falls and left many households and some companies feeling overleveraged.

And it is the attempted deleveraging of those households and companies, and resulting low demand for credit, which far more than impaired credit supply, has been the fundamental driver of seven years of only weak economic recovery.

Markets and commentators largely failed to foresee this, just as they failed before 2007 to see the crisis coming. In spring 2009 almost no one anticipated that central bank policy rates, having been cut close to the zero bound, would stay there for six years and still counting. Almost no one foresaw the depth and length of the post-crisis Great Recession. But we should have foreseen the problems because we had a forewarning – and that forewarning was Japan

Japan, as we all well know, experienced in the 1980s one of the biggest ever credit and real estate booms. That boom then popped in 1990. In its aftermath overleveraged companies were determined to pay down debt, even though the bank of Japan cut interest rates close to zero . The Japanese corporate sector therefore switched from financial deficit to surplus (the red line on Exhibit 4): and the economy entered recession.

As a result the fiscal balance, the blue line on Exhibit 4, moved from surplus to deficit in a natural and also useful response – fiscal stimulus helping to offset the demand impact of attempted private sector deleveraging. But the inevitable consequence (Exhibit 5) was that while corporate sector leverage slowly declined, government debt to GDP increased far more , and total economy leverage, private and public combined, continued to grow.

Debt didn't go away – it simply shifted from the private to the public sector.

And it is that pattern which has been repeated across the rest of the developed world after the crisis of 2008. Exhibit 6 is taken from the recent Geneva Report on “Deleveraging, what Deleveraging ?”,; it shows some limited private sector deleveraging, but a more than offsetting increase in public debt.

Overall across the developed economies (Exhibit 7) total leverage, private and public combined, has not declined at all, but increased significantly since the 2007/8 crisis.

And that appears to leave our conventional policy levers either blunted or in danger of producing adverse side-effects. Thus

- Fiscal deficits are clearly useful in the short term, because they stimulate aggregate nominal demand: but the resulting rise public debt to GDP poses the problem of long-term debt sustainability. In response therefore we have attempted fiscal consolidation: but that is contractionary , as we have seen clearly both in the Eurozone periphery countries, and in Japan, where the sales tax increase of 2014 has had a significant negative demand effect
- So instead, we seek to use ultra-loose monetary policy – interest rates at the zero bound plus quantitative easing- to stimulate demand growth. But such policies carry adverse side-effects They work in part through increased asset prices, but that exacerbates already rising inequality; they stimulate leveraged financial speculations such as carry trades, long before they stimulate real economy investment and consumption: and ultimately they can only work by re-stimulating the very growth in private credit which first produced the crisis and the debt overhang

Once we have excessive debt, we thus seem stuck in a sustained debt deflation trap.

Debt has shifted from developed economy private sectors to public sectors, but also across the world, with a dramatic increase in emerging market leverage as Exhibit 7 shows. This increase has been concentrated in China (Exhibit 8). And it was a direct policy response to debt overhang and attempted deleveraging in the developed world.

Faced with the dramatic downturn of the global economy in late 2008, and fearful of the potential impact on employment in China, the Chinese authorities unleashed an enormous credit boom to finance property and infrastructure development, driving the economy's already very high investment rate from 42% to 48% of GDP, and driving total credit in the economy from 140% of GDP to about 240%.

That credit boom succeeded in underpinning economic and employment growth, but at the expense of enormous imbalances and risks, with 33% of the Chinese economy now in some way related to real estate construction, and 44% of credit extended to finance real estate and related sectors, a percentage far higher than was the case for Korea and Japan when they were at a similar stage of GDP per capita development.

The risks created by this dramatic increase in leverage and real estate investment has now crystallised, with the Chinese economy slowing very significantly over the last six months, driving big reductions in commodity import volumes and prices, and thus imparting a major deflationary effect to economies across the world

Seven years after the 2008 crisis we are therefore still facing the deflationary headwinds created by a severe debt overhang, and we have no clear strategy for actually reducing global debt burdens, rather than simply shifting them around.

We must indeed face the fact that these burdens cannot be reduced simply by paying down debts or growing our way out, but can only be reduced by some combination of debt restructuring/write-off or by permanent monetisation.

In Japan's case for instance, the likelihood that the government of Japan will repay its debts in the normal sense of the word "repay" – i.e. by running a primary budget surplus which achieves debt reduction to some supposedly "sustainable" level – is not just low, it is nil. The IMF Fiscal Monitor, says that this would require (Exhibit 9) a switch from a 6% primary deficit today to 5.6% surplus in 2020, and with that surplus maintained for the whole of the 2020s.

The probability that this will occur is nil: and if attempted – for instance via a series of sales tax increases and expenditure cuts – it would drive the Japanese economy into a deep recession. Japan's government debt will not be repaid, it will be permanently monetised, with the government debt now accumulating rapidly on the Bank of Japan's balance sheet held there in perpetuity.

Ideally such permanent monetisation would happen also in the Eurozone. But it will not occur there, because the Eurozone rules make permanent monetisation impossible, and delayed the launch of even a standard (and supposedly reversible) quantitative easing operation. Eurozone rules have also enforced in the Eurozone far more restrictive fiscal stance than followed in the US, the UK and Japan over the last six years as Exhibit 10 illustrates.

As a result, the Eurozone faces a severe deficiency of domestic nominal demand, and is in danger of suffering a decade or more of very slow growth, very low inflation, and unresolved debt burdens, similar to Japan in the 1990s and 2000s, but with far more severe social and political consequences in culturally and ethnically heterogeneous Europe, than in culturally and ethnically homogeneous Japan

So we are far from out the debt overhang problem, and we face profound deflationary forces across the world.

For individual economies, one answer might seem to be to use ultra-loose monetary policy not, or not solely, to stimulate domestic demand, but in order to drive currency devaluation. Insofar as QE has worked in Japan, it appears to be primarily via this external transmission mechanism: in the Eurozone too, Mario Draghi has several times stressed the desirability of a lower euro, and that has now been achieved. In China too, facing a slowdown as the credit and property investment boom fades, there are now suggestions that a lower renminbi would be desirable.

But all countries together cannot devalue – someone has to appreciate. And today the "appreciator of last resort" is yet again the US dollar, with the rise in the dollar one of the mechanisms by which deflationary headwinds from the rest of the world are transmitted to the US economy. The result will be, that while the Federal Reserve will increase interest rates sometime in the summer or early autumn, the pace of increase will be very very slow.

So where does the UK stand within this deeply deflationary global picture?

Well the UK has now recovered (just) to 2007 GDP levels, with the bursting of the credit and property boom causing less severe harm in the UK than in for instance, Ireland or Spain, for three reasons (I) because the UK did not have a pre-crisis construction boom (II) because significant fiscal stimulus (with deficits averaging 6% of GDP versus 2% in the Eurozone) combined with ultra-loose monetary policy have stimulated demand (III) because a floating exchange rate allowed significant depreciation.

But the recovery is unbalanced. We have not yet managed, despite much talk, to rebalance our economy towards exports and investments, and are running a large current-account deficit of around 5% of GDP. Thus, though to a smaller extent than the US, we are the deficit counterpart to large Eurozone, Chinese and Japanese current account surpluses.

And like the rest of the world, we have no answer to the question of how to reduce accumulated debt levels. Over the next last five years as Exhibit 11 shows, we have achieved significant privately deleveraging, but with a more than offsetting increase in public leverage. Over the next five years, we anticipate that public debt to GDP will stabilise and then begin to fall, but our independent Office of Budget Responsibility forecasts that this will only be compatible with a robust growing economy, if private debt to GDP reverses all of its decline and returns to levels above the pre-crisis peak, with total leverage, public and private combined, higher in 2020 than ever before.

Thus having shifted debt from the private to the public sector, we will simply shift it back again.

So we have unresolved macro imbalances. But more relevant to political consequences, we also have a very incomplete and uneven recovery in terms of what matters to ordinary people- their standard of living.

GDP is back to 2007 levels, but GDP per capita is still slightly below pre-crisis levels, and median real wages are some 7% below 2008 levels. GDP growth has in part simply reflected population and workforce growth: and strong employment growth has been combined with very low productivity growth and falling real wages. Asset values for significant wealth owners – whether in bonds, equities or London property – have however very significantly increased

The result is a sour political mood, with trust in elites and established parties very low as we enter a pre-election period. In the May general election our two major political parties – Conservative and Labour – will between them not get more than 65% of the vote. In England, some 15% of the vote will go to the UK Independence party (UKIP), whose biggest vote winning issue is immigration, and which wants Britain to leave the European Union. In Scotland, despite last year's narrow 55/45 defeat of the independence referendum, the Scottish Nationalist party are likely to take the majority and perhaps the vast majority of seats, wiping out Labour's traditional dominance.

We will almost inevitably have another coalition government.

- If it is Conservative led , we will have a referendum on British membership of the European Union, with – I estimate – a 60% chance of us staying in but a 40% chance of us leaving
- And if we have a Labour led coalition, the Conservative party will swing in a Eurosceptic direction, and will likely fight the subsequent election in an electoral pact with UKIP , leading to a referendum at a later stage, but with then a greater chance of a vote if favour of exit
- And if Britain leaves the European Union, Scotland will leave the United Kingdom

We are in fractious political times: and the underlying cause lies in the post-crisis Great Recession, as we struggle with the still unresolved issues of debt overhang and deflationary headwinds left behind by excessive debt creation in the decades before 2008