SURVIVING THE DEBT STORM

GETTING CAPITALISM BACK ON TRACK

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Introduction

October 24th 2019, the 90th anniversary of the Wall Street Crash, is the third anniversary of the even worse Great Default – the day when a bank too big to fail proved to be too big to bail out. Its failure triggered a chain reaction of defaults that collapsed the Ponzi scheme of insolvent banks supporting the insolvent governments that guaranteed the liabilities of the insolvent banks. Public and private defaults combined to slash money supplies in OECD countries and the consequent soaring real interest rates decimated stock, commodity, precious metals and housing prices and caused the deepest depression in recorded history throughout Europe and North America.

Banking system collapses have annihilated credit markets and even the few borrowers with investment-grade credit ratings cannot borrow. Conditions are worse than when the monetary system collapsed in 1931. Government revenue streams have shrunk to a trickle and services have shrivelled commensurately. Benefits are virtually non-existent, so civil disobedience and violence continue to rise. Developed countries' great expectations for emerging country growth to provide export markets vanished, with China plummeting into prolonged recession. Instead, China is trying to distract its increasingly restive population from their problems with an aggressive foreign policy that has now caused a naval clash with the US Seventh Fleet in the South China Sea and …

Can this actually happen?

Indeed it can! This book is a searing indictment of banks and the agenda that has been adopted by governments and central banks. It makes the compelling case that, because of the gargantuan efforts to derail the deleverage that is inevitable after the collapse of the greatest credit bubble of all time, the authorities have placed themselves in the middle of a 'damned if they do and damned if they don't' situation that will ultimately result in a considerably more painful correction of global and national imbalances than necessary. At its worst, the unfolding of this crisis could feature:

- bank failures and nationalisation of financial institutions and significant shortages of the capital needed to recapitalise banks;
- sovereign, non-financial corporate and household defaults;
- falling global savings and rising global real interest rates;
- plummeting asset prices – stocks, bonds, housing, commodities, precious metals, etc;
- dysfunctional capital markets;
- falling money supplies, in spite of massive money printing, causing lower real incomes and negative output growth in developed countries;
- central banks financing massive government deficits;
- higher taxes and reduced government services and benefits;
- exits from the euro;
- a sharp drop in China's trend growth rate with bank recapitalisations and weak yuan.

Yet it is still not too late to choose a different path.

Implementing the hubristic hypothesis that fiscal and monetary policy can always avoid boom-and-bust has placed developed countries firmly in the path of the greatest bust of all time. This book will show that we created the biggest credit bubble of all time by ignoring the lessons past crises had taught. It goes on to show how all the favourable conditions that helped recovery from past crises have turned unfavourable and explains how the euro-zone crisis compares with past events. It then shows how unwarranted fear of deflation has resulted in policies that have been counterproductive, and describes policies that could help correct imbalances and the restructuring that is necessary to return to optimal growth and robust financial markets. In short, it explains what we need to do to get from where we are to where we want to be.

1

Why bubbles? Why do they always burst?

Economic theory assumes all people know all the relevant facts concerning all their economic decisions and always act rationally on the information – 'rational man'. The efficient markets hypothesis asserts that financial markets embody all the information that can affect prices. If so, consistently achieving above-average market-risk-adjusted returns would be impossible and the entire industry devoted to financial analysis would be superfluous. Nevertheless, 'rational man' + efficient markets = predictability, so mathematical computer models based on these assumptions have proliferated. Blind faith in their ability to predict the future with decimal-point accuracy, to price complicated asset structures correctly and to accurately identify all possible sources of risk led to an explosion in the amount of debt outstanding and rapidly rising leverage up to the financial crisis in 2008–09.

'Rational man' does not exist – and never did. Desires and fears, i.e. emotions, drive all human activity. They are neither rational nor linear, so they cannot be modelled. However, they do fluctuate within given parameters – most of the time. Resulting behaviours can be modelled as long as the emotions stay within the parameters and historical relationships continue. This is a big ask and gives rise to another three problems that bedevil model predictions. First, extreme events pop up far more frequently than mathematical theory predicts. Second, models cannot predict when an extreme event will occur. Third, they cannot give any reliable information on an extreme event – even after it has occurred – so the models still cannot incorporate the effects of the end of over half a century of ever-increasing leverage on economies and financial markets.

Furthermore, many analysts ignore financial debt when computing debt-to-GDP ratios – odd, because excess financial debt always causes or exacerbates financial crises. Financial debt in the US fell 20% from its high at the end of 2008 while rising 10% in Europe, so the next banking crisis should start in Europe, where the creditworthiness of sovereign debt has fallen alarmingly in some of the peripheral states.[1] Moreover, bankers on both sides of the Atlantic are continuing to make two serious errors that were major factors in the banking crisis of 2007–8:

- putting more reliance on computer models than on common sense;
- failing to purge bank balance sheets of failing assets due to inadequate net tangible equity to absorb the losses.

Contrary to the hype, computer models are highly fallible. (Remember 'garbage in = garbage out'?) They greatly underestimated financial risk by failing to incorporate obvious correlations and, for example, rated securities based on home equity loans and subprime mortgages AAA. Reliance on computer models also explains the failure to spot turning points. Only external shocks can divert models from moving towards equilibrium. All computer-driven forecasts tend to be straight lines towards equilibrium positions. Computer models do not, and probably never will, identify turning points.

Failure to adequately price complex financial instruments, especially collateralised debt obligations (CDOs), was a major factor in the 2007–08 subprime crisis. Securitisation effectively hedged the specific factors leading to default, such as personal illness, but failed completely to address the risks common to the entire securitised pool, such as an economic downturn and rising unemployment. Investors in the euro zone mispriced sovereign debt for a prolonged period of time, but for a different reason – the false assumption that a common monetary policy plus the political promise that no country in the region would default reduced sovereign risk within the euro.

Emotions exceeding known parameters cause extreme events, such as stock-market booms and busts. They are self-reinforcing spirals upward and especially downward that, once established, keep diverging from equilibrium until the driving forces fade or stronger counter-forces reverse them. Ever-increasing desires for accumulating ever-greater wealth faster and faster ignited a credit bubble that spiralled upwards until dwindling numbers of new borrowers burst the bubble in 2008. The multi-decade credit bubble and its bursting were extreme events. No model recognised the credit bubble for what it was, so could not predict its collapse. What is more, no model is giving any indication of the plethora of problems brewing in Europe.

Economists' inability to see self-reinforcing spirals has caused a long argument about whether the main cause of recessions and depressions is:

- an inherent tendency to overproduction within the capitalist economic system itself; or
- external shocks causing underconsumption.

The debate is unlikely to end because neither hypothesis is verifiable. This book will show that the main cause of recessions and depressions is that the interaction of human fear and greed produces recurrent cycles. However, distinguishing one cycle from another is hard. Cycles of different lengths and amplitudes interact, so they defy rigorous statistical analysis. By contrast, overproduction is only one aspect of human greed and shocks produce only random change. Consequently, analysis of underconsumption relies on abstract models that freeze all but a few variables to determine the effects of the remaining factors. Unfortunately, these models infer an equilibrium that exists only in theory and their adherents can always come up with factors to explain their failure to produce the predicted outcomes.

Both money and credit variables exhibit recurring long-term cycles. Repetitive behaviour underlies those cycles. As Mark Twain said, 'History does not repeat itself, but it does rhyme.' Rhyme creates repeating patterns that, over relatively consistent periods of time, constitute cycles. It is important to remember that cycles are not predetermined patterns, but the natural outcome of the inputs that have occurred. Charles Mackay initiated the discussion of credit cycles in his book *Extraordinary Popular Delusions and the Madness of Crowds*, first published in 1841. Present-day economists still refer to the three chapters on economic bubbles. Irving Fisher's theory of debt deflation advanced the study of credit cycles in 1933 by discovering the following sequence of eight events after credit bubbles burst, which causes