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Debt Deflation: A Long Economic Winter Ahead

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> "A State divided into a small number of rich and a large number of poor will always develop a government manipulated by the rich to protect the amenities represented by their property.": Harold Laski (1893-1950), British political theorist, 1930
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> "Money becomes evil not when it is used to buy goods but when it is used to buy power… economic inequalities become evil when they are translated into political inequalities." Samuel Huntington (1927-2008), political scientist
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> "… if financial markets are skittish and don't have confidence in a country's fiscal soundness, that is also going to undermine our recovery." President Barack Obama, June 25, 2010
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> "Any intelligent fool can make things bigger, more complex, and more violent. It takes a touch of genius, and a lot of courage to move in the opposite direction." Albert Einstein (1879-1955) Physicist and Professor, Nobel Prize 1921

The bond market is telling us that there could be hard economic times ahead and that deflation, for the time being, is more of a threat than inflation. Leading indicators are also pointing to possible economic weakness ahead.[http://www.dailyfinance.com/story/leading-indicators-philly-fed-survey/19520197/]

-The Euro zone is being pulled apart by the economic asymmetry of its members, the less productive among them (Greece , Spain , Ireland , Portugal and Italy) being unable to keep pace with the very productive German economy. -The U.S. money supply M3 is contracting.

-The Chinese bubble is dangerously approaching the bursting point. [http://www.thestar.com/opinion/article/778682–is-chinese-economic-bubble-about-to-burst]

-And, the deflation of debt all over the place threatens to plunge the world economy into a deflationary tailspin. —In this context, there is a good chance of a double-dip recession next year, in 2011. [http://business.financialpost.com/2010/06/29/u-s-double-dip-recession-is-officially-coming-analyst-warns/]

Readers of this blog know where I stand on this issue. One year ago, on July 10, 2009, when everybody and his uncle was declaring the recession over and the return of business as usual, I wrote a piece announcing that my analysis was pointing out to ten years of economic hardship entitled “We are in the Midst of the Great Baby-Boomers Economic Stagnation of 2007-2017” [http://www.TheNewAmericanEmpire.com/tremblay=1113] I wrote then that “many observers think that ‘prosperity is around the corner’ and that this recession, like others since World War II, will end as soon as the stock market, as a leading indicator, recovers and people start spending again. This is a myopic view of the current economic big picture.”

Let us keep in mind that in May of 1930, President Herbert Hoover was also proclaiming that “the danger … is safely behind us.” This was ten years too early for such a declaration. Just as in the 1930s, the U.S. economy and many part of the world economy suffer from a debt overhang that usually takes at least ten years to correct. When overall debt is four times larger than the economy, as it is the case today and as it was close to being the case in the 1930s, a debt deflation becomes unavoidable.

Economic booms built on a mountain of debt, some of which is fraudulent and speculative debt, tend to end badly. The higher the debt mountain relative to the real economy, the more serious is the following economic meltdown. [http://lexicon.ft.com/term.asp?t=real-economy] This is because an unsustainable debt level means that some of the investments and projects thus financed make no economic sense and no sufficient income can be forthcoming to service and repay the debts. The first consequence is excess capacity and falling asset prices. The second consequence is an unavoidable liquidation of debts and a debt deflation. The third consequence is economic stagnation.

The danger that accompanies a protracted period of debt-liquidation and debt deflation after a binge of over-indebtedness is well known in economics. In 1933, Yale economist Irving Fisher published his debt-deflation theory of economic depressions[http://fraser.stlouisfed.org/docs/meltzer/fisdeb33.pdf] . The core of the theory is that over-indebtedness leads to deflation, which in turn leads to an economic contraction. Fisher summarizes the links between debt liquidation and economic contraction in nine interacting steps:

1- Debt liquidation leads to distress selling.

2- Contraction of deposit currency, as bank loans are paid off, and to a slowing down of the velocity of circulation of money.

3- A fall in the level of prices.

4- If the fall of prices is not interfered with by reflation or otherwise, this is followed by greater fall in the net worth of business, precipitating bankruptcies.

5- This leads to a like fall in profits.

6- A reduction in construction, output, trade and in employment of labor results.

7- Losses, bankruptcies and unemployment lead to pessimism and loss of confidence.

8- The result is hoarding and a contraction in bank credits, which contribute in slowing down even more the velocity of circulation of money.

9- The overall deflation causes a fall in the nominal or money interest rates accompanied by a rise in the real or commodity rates of interest as prices fall.

A similar self-reinforcing spiral-down of debt-deflation and economic contraction can be feared in the coming years as the level of debt to the economy goes from about four times the economy to a more manageable two times the economy. In other words, it should not take more than $1.50 or $2 of new debt and credit to generate one dollar of new output. When it takes more debt than that to generate new production, this is an indication that the economy is becoming over-leveraged with debt.

Judging by the pronouncements made by leaders at the recent G8 and G20 meetings in June, and their collective commitment to cut governments' deficits in half by 2013, I don't think that politicians fully understand the danger presently facing the world economy. [http://www.nationalpost.com/Official+Summit+Communiqué/3208710/story.html]

In fact, any new shock hitting the world economy, economic or political, risks accelerating the collapse of the debt house of cards, with dire consequences for production and employment.

Austerity fiscal measures may raise government efficiency, but they are not what will cushion the real effects of the debt deflation. Both reflationary monetary policies and overall stabilization policies are needed, especially in the banking sector, in order to make sure that producers and employers are not frozen out of new bank credit.

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