We are trapped in a cycle of credit booms

By Martin Wolf

Author alerts

The eurozone seems to be waiting for the Godot of global demand to float it off into debt sustainability.

Huge expansions in credit followed by crises and attempts to manage the aftermath have become a feature of the world economy. Today the US and UK may be escaping from the crises that hit seven years ago. But the eurozone is mired in post-crisis stagnation and China is struggling with the debt it built up in its attempt to offset the loss of export earnings after the crisis hit in 2008.

Without an unsustainable credit boom somewhere, the world economy seems incapable of generating growth in demand sufficient to absorb potential supply. It looks like a law of the conservation of credit booms. Consider the past quarter century: a credit boom in Japan that collapsed after 1990; a credit boom in Asian emerging economies that collapsed in 1997; a credit boom in the north Atlantic economies that collapsed after 2007; and finally in China. Each is greeted as a new era of prosperity, to collapse into crisis and post-crisis malaise.

The authors of a fascinating new report, Deleveraging: What Deleveraging?, do not entertain my dystopian hypothesis. Rightly or wrongly, they consider these credit cycles to be essentially independent events. Yet the report is invaluable. It brings out clearly the limited nature of post-crisis deleveraging, the plight of the eurozone and the big challenges now facing China.

If you look at the world as a whole, there has been no aggregate deleveraging since 2008. The same holds for the high-income economies, viewed as a single bloc. Financial sectors have deleveraged in the US and UK, however; so, too, have households in the US and, to a lesser degree, the UK. Liabilities of households have even converged between the US and the eurozone as a whole (see charts).

Meanwhile, public debt has risen sharply. That financial crises lead to jumps in fiscal deficits was one of the most important findings of This Time is Different by Harvard’s Kenneth Rogoff and Carmen Reinhart. Since the crisis, the ratio of public debt to gross domestic product has jumped by 46 percentage points in the UK and 40 points in the US, against 26 points in the eurozone. Even in the US, where private deleveraging has been rapid, overall deleveraging has been small. This need be no disaster: if the government’s balance sheet is more robust than those of much of the private sector, it ought to take the strain.

Since 2007 the ratio of total debt, excluding the financial sector, has jumped by 72 percentage points in China, to 220 per cent of GDP. One can debate whether this level is sustainable. One cannot debate whether such a rapid rate of rise is sustainable; it cannot possibly be so. The rise in debt has to halt with possibly significantly more adverse effects on China’s rate of growth than today’s consensus expects.
possible outcomes into three categories: in “type 1”, such as Sweden in the early 1990s, the level of output falls, never to regain its pre-crisis trend, but the growth rate recovers; in the more damaging “type 2”, as in Japan since the 1990s, there is no absolute fall in output, but potential growth falls far short of the pre-crisis rate; finally, in “type 3”, as in the eurozone now and probably the US and UK, there is both a fall in output and a permanent fall in potential growth.

Several possible reasons exist for such permanent losses of output and growth. One is the pre-crisis trend was unsustainable. Another is the damage to confidence and so investment and innovation from a financial crisis. But among the most important is the debt overhang. As the report shows, deleveraging is hard. Mass bankruptcy, as in the 1930s, is devastating. But working out of debt is likely to generate a vicious circle from high debt to low growth and back to even higher debt.

Today long-term interest rates are low in high-income economies. In the eurozone this is largely due to the promise by Mario Draghi, the European Central Bank president, in July 2012 to do “whatever it takes”. Unfortunately, the growth of nominal GDP in the eurozone is also dismal: inflation is ultra-low and real GDP is growing weakly, under the blows of fiscal retrenchment and structurally inadequate private demand.

Incredibly, the eurozone seems to be waiting for the Godot of global demand to float it off into growth and so debt sustainability. That might work for the small countries. It is not going to work for all of them. The report talks of a “poisonous combination . . . between high and higher debt and slow and slowing (both nominal and real) GDP growth”. The euro periphery, it adds, is where this perverse loop of debt and growth is severe. That is no surprise. Crisis-hit eurozone countries have been running to go backwards. The policies of the eurozone rule out needed growth.

Managing the post-crisis predicament requires a combination of prompt recognition of losses, recapitalisation of the banking sector and strongly supportive fiscal and monetary policies (where those are feasible) to sustain economic growth. The aim should be to use both blades of the scissors: direct debt reduction and recapitalisation on the one hand and strong economic growth on the other. The US has come closest to getting this combination right.

Yet the biggest lesson of these crises is not to let debt run ahead of the long-term capacity of an economy to support it in the first place. The hope is that macroprudential policy will achieve this outcome. Well, one can always hope.

These credit booms did not come out of nowhere. They are the outcome of the policies adopted to sustain demand as previous bubbles collapsed, usually elsewhere in the world economy. That is what has happened to China. We need to escape from this grim and apparently relentless cycle. But for now, we have made a Faustian bargain with private sector-driven credit booms. A great deal more trouble surely lies ahead.

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