Recession Is Over; Depression Has Just Begun

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For the last few months I have been casting around looking for bullish data points as counterfactuals to my more bearish long-term outlook. I have found some, but not enough. If you recall, early this year, I stated that we are in depression, making the case for the ongoing downturn as a depression with a small 'd.' Nevertheless, I was quite optimistic about the ability of policymakers to engineer a fake recovery predicated on stimulus and asset price reflation and I certainly saw this as bullish for financial shares if not the broader stock market. But, I saw these events as temporary salves for a deeper structural problem.

As a result, I have been on a quest to find data which disproves my original thesis – signs that the green shoots that everyone keeps talking about (and a term I had banned from my site) are part of a sustainable economic recovery. Unfortunately, I have concluded that they are not. **This post will discuss why we are in a depression, not a recession and what this means about likely future economic and investing paths**. I will try to pull together a number of threads from previous posts, add some context via Wikipedia links and draw in some good discussion via recent posts by Prieur du Plessis on balance sheet recessions and Marshall Auerback on the sector financial balances model of economics which completed the picture for me.

This post is very long and I have had to shorten it in order to pull all of the ideas into one post. Please do read the linked posts for background as I left out some of the detail in order to create this narrative.

Let's start here then with the crux of the issue: debt.

Deep recession rooted in structural issues

Back in my very first post in March of 2008, I said that the U.S. was already in a recession, the only question being how deep and how long – a question I answered in the next post saying "we are definitely in recession. And according to Gary Shilling, this recession is going to be a big one. Worse than 2001, 1990-91 or the double dip recession of 1980-82." This has certainly turned out to be true. The issue was and still is overconsumption i.e. levels of consumption supported only by increase in debt levels and not by future earnings. This is the core of our problem – debt.

I see the debt problem as an outgrowth of pro-growth, anti-recession macroeconomic policy which developed as a reaction to the trauma of the lost decade in the U.S. and the U.K.. This was a period of low growth, high inflation and poor market returns, in which the U.K. became the sick man of Europe and labor strife brought that economy to its knees. It is a period that saw the resignation of an American President and the humiliation of the Iran Hostage Crisis.

In essence, after the inflationary outcome that many saw as an outgrowth of the Samuelson-Keynesianism of the 1960s and 1970s, the Reagan-Thatcher era of the 1990s ushered in a more 'free-market' orientation in macroeconomic policy. The key issue was government intervention. Policy makers following Samuelson (more so than Keynes himself) have stressed the positive effect of government intervention, pointing to the Great Depression as animus, and the New Deal, and World War II as proof. Other economists (notably Milton Friedman, and later Robert Lucas) have stressed the primacy of markets, pointing to the end of Bretton Woods, the Nixon Shock and stagflation as counterfactuals. They point to the Great Moderation and secular bull market of 1982-2000 as proof. This is a divisive and extremely political issue, in which the two sides have been labelled Freshwater and Saltwater economists (see my post "Freshwater versus saltwater circa 1988").

However, just as the policy of the 1950s to the 1970s was not really Keynesian (read Keynes' General Theory as Richard Posner did and you will see why), the 1980s-2000 was not really an era of true 'free markets.' I call it deregulation as crony capitalism. What this has meant in practice is that the well-connected, particularly in the financial services industry, have won out over the middle classes (a view I take up in "A populist interpretation of the latest boom-bust cycle"). In fact, hourly earnings peaked over 35 years ago in the United States when adjusting for inflation.

Remember, the 1970s was a difficult period in which the U.K. and the U.S. saw jobs vanish in key industrial sectors. To stop the rot and effectively mask the lack of income growth by average workers, a new engine of growth had to be found. Enter the financial sector. The financialization of the American and British economies began in the 1980s, greatly increasing the size and impact of the financial sector (see Kevin Phillips' book "Bad Money"). The result was an enormous increase in debt, especially in the financial sector.

This debt problem was made manifest repeatedly during financial crises of the era. Not all of these crises were American – most were abroad and merely facilitated by an increase in credit, liquidity, and international capital movement. In March 2008, I wrote in my third post on the US economy in 2008:

From the very beginning, the excess liquidity created by the U.S. Federal Reserve created an excess supply of money, which repeatedly found its way through hot money flows to a mis-allocation of investment capital and an asset bubble somewhere in the global economy. In my opinion, the global economy continued to grow above trend through to the new millennium because these hot money flows created bubbles only in less central parts of the global economy (Mexico in 1994-95, Thailand and southeast Asia in 1997, Russia and Brazil in 1998, and Argentina, Uruguay, and Brazil in 2001-03). But, this growth was unsustainable as the global imbalances mounted.

Eventually, the debt burdens became too large and resulted in the housing meltdown and the concomitant collapse of the financial sector, a looming problem that our policymakers should have seen. This is why my blog is named Credit Writedowns. But, make no mistake, the housing and writedown problems are only symptoms. The real problem is the debt – specifically an overly indebted **private** sector (note the phrase 'private sector' as I will return to this topic).

This is a depression, not a recession

When debt is the real issue underlying an economic downturn, the result is a period of stagnation and short business cycles as we have seen in Japan over the last two decades. This is what a modern-day depression looks like – a series of W's where uneven economic growth is punctuated by fits of recession. A recession is merely a period of recalibration after businesses get ahead of themselves by overestimating consumption demand and are then forced to cut back by making staff redundant, paring back inventories and cutting capacity. Recessions can be overcome with the help of automatic stabilzers like unemployment insurance to cushion the blow. Depression is another event entirely. Back in February, I highlighted a blurb from David Rosenberg which summed up the differences between recession and depression quite well.

Depressions marked by balance sheet compression
Recessions are typically characterized by inventory cycles – 80% of the decline in GDP is typically due to the de-stocking in the manufacturing sector. Traditional policy stimulus almost always works to absorb the excess by stimulating domestic demand. Depressions often are marked by balance sheet compression and deleveraging: debt elimination, asset liquidation and rising savings rates. When the credit expansion reaches bubble proportions, the distance to the mean is longer and deeper. Unfortunately, as our former investment strategist Bob Farrell's Rule #3 points out, excesses in one direction lead to excesses in the opposite direction.

The next day, I highlighted Ray Dalio's version of this story because it takes a historical view and rightly emphasizes the debtor instead of the lender as the crux of the problem. Notice the part about printing money and devaluing the currency if the debt is in your own currency.

… economies go through a long-term debt cycle — a dynamic that is self-reinforcing, in which people finance their spending by borrowing and debts rise relative to incomes and, more accurately, debt-service payments rise relative to incomes. At cycle peaks, assets are bought on leverage at high-enough prices that the cash flows they produce aren't adequate to service the debt. The incomes aren't adequate to service the debt. Then begins the reversal process, and that becomes self-reinforcing, too. In the simplest sense, the country reaches the point when it needs a debt restructuring…

This has happened in Latin America regularly. Emerging countries default, and then restructure. It is an essential process to get them economically healthy.

We will go through a giant debt-restructuring, because we either have to bring debt-service payments down so they are low relative to incomes — the cash flows that are being produced to service them — or we are going to have to raise incomes by printing a lot of money.

Commence the fake recovery

So where are we, then? We have left the fake recovery and are entering a new era of growth that could last as long as three or four years or could peter out very quickly in a double dip recession. By now, you have seen my post on the fake recovery, so I won't cover that ground here. However, I do want to highlight how I came to believe in the fake recovery and how asset prices have played into this period (the S&L crisis played out nearly the same way). I see writedowns as core to the transmission mechanism of debt and credit problems to the real economy via reduced supply and demand for credit. Again, this is why my site is called Credit Writedowns.

In March, at the depths of the downturn I wrote:

> *The problem is the writedowns. You see, if you get $30 billion in capital from the government, but lose another $40 billion because of credit writedowns and loan losses, you aren't going to be lending any money. To me, that says **the downturn will only end when the massive writedowns end, not before**.*
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> *The U.S. government has finally realized this and is now moving to stem the tide. Their efforts point in four directions:*
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> ***Increase asset prices**. If the assets on the balance sheets of banks are falling, then why not buy them at higher prices and stop the bloodletting? This is the purpose of the TALF, Obama's mortgage relief program and the original purpose of the TARP.*
>
> ***Increase asset prices**. If assets on the balance sheet are falling, why not eliminate the accounting rules that are making them fall? Get rid of marking-to-market. This is the purpose of the newly proposed FASB accounting rule change.*
>
> ***Increase asset prices**. If asset prices on the balance sheet are falling, why not reduce interest rates so that the debt payments which are crushing debtors ability to finance those assets are reduced? This is why short-term interest rates are near zero.*
>
> ***Increase asset prices**. If asset prices on the balance sheet are falling, why not create Public-Private partnerships to buy up those assets at prices which reflect their longer-term value? This is what Geithner's Capital Assistance Program is designed to do.*
>
> *So I lied, there is only one direction the government is headed: increase asset prices (or, at least keep them from falling). Read White House Economic Advisor Larry Summers' recent prepared remarks to see what I mean. (Summers on How to Deal With a 'Rarer Kind of Recession' – WSJ)*

I was more on target in my thinking here than I could have known. Within two weeks, the mark-to-market model was dead and mark-to-make believe had begun. It was then that I knew a recovery was likely to take hold. And it was going to be bullish for bank stocks and the broader market. What you should realize is that, despite the remaining problems in credit cards, commercial real estate or high yield loans, limiting credit growth, the changes instituted by government definitely have meant 1. that banks will earn a shed load of money and 2. that house price declines have stalled, underpinning the asset base of lenders. This necessarily means an end to massive writedowns, a firming of banks' capital base, and a reduction in private sector deleveraging.

As an aside, I should mention that this dynamic called the asset-based economy, where economic well-being is dependent on asset prices, is far more pronounced in Anglo-Saxon countries like the U.S. and the U.K. (and Australia, Ireland, and Canada to a degree). While the free market ideal has gained sway globally, it is viewed with much more skepticism elsewhere. In Germany, for example, the term Anglo-Saxon is often bandied about as an epithet for political demagoguery to represent free market ideology. These cultural differences are something I explored in my post "Cultural attitudes on work, leisure and wealth in Europe and America"

As for the recent asset-based economic reflation, be under no illusion that these measures 'solve' the problem. The toxic assets are still impaired and banks are still under-capitalized. But the increased asset value and the end of huge writedowns has underpinned the banks and led to a rise in the broader market in a feedback loop that has been far greater than I could have imagined at this stage in the economic cycle.

The double dip or the economic boom?

So what's next? A lot of the economic cycle is self-reinforcing (the change in inventories is one example). So it is not completely out of the question that we see a multi-year economic boom Higher asset prices, lower inventories, fewer writedowns all lead to higher lending capacity, higher cyclical output, more employment opportunities and greater business and consumer confidence. If employment turns up appreciably before these cyclical agents lose steam, you have the makings of a multi-year recovery. This is how every economic cycle develops. This one is no different in this regard.

However, longer-term things depend entirely on government because we are in a balance sheet recession. Ray Dalio and David Rosenberg make this case well in the previous quotes I supplied, but it was a recent post about Richard Koo from Prieur du Plessis which got me to write this post. His post, "Koo: Government fulfilling necessary function" reads as follows:

> *According to Koo, American consumers are suffering from a balance sheet problem and will not increase consumption until their personal finances are back in order. The banks are not lending mainly because nobody wants to borrow and, furthermore, the banks want to build their own balance sheets (raise cash) and get rid of toxic garbage…*
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> *Again, when asked what would happen if the government cuts back on its fiscal stimulus, Koo replies: "Until the private sector is finished repairing its balance sheets, if the government tries to cut its spending, we're going to fall into the same trap Franklin Roosevelt fell into in 1937 (a crushing bear market) and Prime Minister Hashimoto fell into in 1997, exactly 70 years later.*
>
> *"The economy will collapse again and the second collapse is usually far worse than the first. And the reason is that, after the first collapse, people tend to blame themselves. They say, 'I shouldn't have played the bubble. I shouldn't have borrowed money to invest – to speculate on these things.'*

This view of a second, more serious downturn mirrors the one I wrote of when I wrote about high structural unemployment last week. And, again, it is predicated on what government does. I wrote last November that if government stops the support, recession is going to happen

> *The U.S. economy cannot possibly work itself out of the greatest financial crisis in some 70-odd years in a mere 4 years and then expect to raise taxes on the middle class without a major recessionary relapse.*
>
> *So, when you hear policy makers talking about reducing the deficit as soon as possible, what you should think is 1938 and continued depression.*

Right now, if you listen to what President Obama is likely to do when we see more economic growth, you know that the government prop for the economy is going to be taken away. Koo again:

> *So the fact that Larry Summers was talking about 'temporary' fiscal stimulus had me very, very worried. That whole Larry Summers idea that one big injection of fiscal stimulus will get the US out of the recession, and everything will be fine thereafter, probably led to President Obama's saying he's going to cut his budget deficit in half in four years."*

Get ready because the second dip **will** occur. It will be nasty: unemployment will be **higher** and stocks will go **lower** than in 2009. I am convinced that it is politically unacceptable to have the government propping up the economy as Koo suggests it should. The question now is one of timing: when will the government stop propping up the economy? **The more robust the recovery, the quicker the prop ends and the sooner we get a second leg down**.

So to recap:

1. A depression was borne out of high levels of private sector debt, the unsustainability of which became apparent after a financial crisis.
2. The effects of this depression have been lessened by economic stimulus and government support.
3. Government intervention led to a reduction in asset price declines, which led to stock market increases, which led to asset price stabilization and more stock market increases and eventually to asset price increases. This has led to a false sense that green shoots are leading to a sustainable recovery.
4. In reality, the problems of high debt levels in the private sector and an undercapitalized financial system are still lurking, waiting for the government to withdraw its economic support to become realized

5. Because large scale government deficit spending is politically impossible, expect a second economic dip within three to four years at the latest.

Why is government spending necessary?

The government plays a crucial role here because of the huge private sector indebtedness. In the U.S. and the U.K., the public sector is not nearly as indebted. So while, the private sector rebuilds its savings and reduces debt, the public sector **must** pick up the slack. Why do I say must? It's because of an accounting identity which comes from the financial sector balances model. Marshall Auerback says it best in a recent post:

> *We've said it before and we'll say it again. As a matter of national accounting, the domestic private sector cannot increase savings unless and until foreign or government sectors increase deficits. Call this the tyranny of double entry bookkeeping: the government's deficit equals by identity the non-government's surplus.*
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> *So, if the US private sector is to rebuild its balance sheet by spending less than its income, the government will have to spend more than its tax revenue. The only other possibility is that the rest of the world stops saving on a massive scale — letting the US run a current account surplus. But that is highly implausible and socially undesirable, since it means we export our economic output, rather than consume it domestically. And if the government deficit does not grow fast enough to meet the saving needs of the private domestic sector, national income will decline, which, given the size of the private sector's debt problem, will generate a huge debt deflation.*
>
> *This is the foundation of modern monetary theory. Would that the IMF and the G20 understood these basic facts.*

If the private sector is a net saver, the public sector must, I repeat must, run a deficit. That's the law of double entry book-keeping. The only other way to prevent the government from running a deficit when the private sector is net saving is to run huge current account surpluses by exporting your way out of recession – what Germany and Japan tried in the 1990s and in this decade. But, of course, the G20 and the IMF are all talking about global re-balancing. This cult of zero imbalances is something Marshall first brought forward back in April. And it ignores the accounting identity inherent in the financial sector balances model. I highlighted this model in my post, "Minsky: Turning neoclassical economics on its head." However, I must admit to having a preternatural disaffection for large deficits and big government which is what Koo and Minsky advise respectively – a recent cartoon shows why. It is this knee-jerk aversion to what is viewed as fiscal profligacy which is at the core of the cult of zero imbalances.

So, what does this mean for the American and global economy?

1. The private sector (particularly households) is overly indebted. The level of debt households now carry cannot be supported by income at the present levels of consumption. **The natural tendency, therefore, is toward more saving and less spending in the private sector (although asset price appreciation can attenuate this through the Wealth Effect)**. That necessarily means the public sector must run a deficit or the import-export sector must run a surplus.
2. Most countries are in a state of economic weakness. That means consumption demand is constrained globally. There is no chance that the U.S. can export its way out of recession without a collapse in the value of the U.S. dollar. That leaves the government as the sole way to pick up the slack.
3. Since state and local governments are constrained by falling tax revenue (see WSJ article) and the inability to print money, only the Federal Government can run large deficits.
4. Deficit spending on this scale is politically unacceptable and will come to an end as soon as the economy shows any signs of life (say 2 to 3% growth for one year). Therefore, at the first sign of economic strength, the Federal Government will raise taxes and/or cut spending. The result will be a deep recession with higher unemployment and lower stock prices.
5. Meanwhile, all countries which issue the vast majority of debt in their own currency (U.S, Eurozone, U.K., Switzerland, Japan) will inflate. They will print as much money as they can reasonably get away with. While the economy is in an upswing, this will create a false boom, predicated on asset price increases. This will be a huge bonus for hard assets like gold, platinum or silver. However, when the prop of government spending is taken away, the global economy will relapse into recession.
6. As a result there will be a Scylla and Charybdis of inflationary and deflationary forces, which will force the hands of central bankers in adding and withdrawing liquidity. Add in the likely volatility in government spending and taxation and you have the makings of a depression shaped like a series of W's consisting of short and uneven business cycles. The secular force is the D-process and the deleveraging, so I expect deflation to be the resulting secular trend more than inflation.
7. Needless to say, this kind of volatility will induce a wave of populist sentiment, leading to an unpredictable and violent geopolitical climate

and the likelihood of more muscular forms of government.

8. From an investing standpoint, consider this a secular bear market for stocks then. Play the rallies, but be cognizant that the secular trend for the time being is down. The Japanese example which we are now tracking is a best case scenario.

Not particularly uplifting, but hopefully well-documented. Your comments are very greatly appreciated.