Balance sheet recessions explained – why the West will have low growth next 5-20 years.
By Bruce Baker 22/9/14 - updated 23/5/15 for clients of Puzzle Financial Advice

Range of reasons you should be expecting low returns from many western developed world share markets:

- The Western developed world commenced a balance sheet recession in 2008 (the Global Financial Crisis). A key feature of balance sheet recession is excess debt on the economy. Now many western developed economies have a debt bubble of extreme historic proportions.
  - http://en.wikipedia.org/wiki/Balance_sheet_recession
- The US share market has extremely high valuations as measured by the Shiller P/E ratio (CAPE 10). Shiller shows that the historical data supports the intuitive notion that if you buy shares at high valuations (as assessed using the CAPE 10), then the probabilities are that you will get poor or negative returns over the next 10-20 years on average.

Balance sheet recessions are very important to understand because if you understand what balance sheet recessions are, you will understand why the Western developed world on very broad averages, is highly likely to experience (by historical standards) very low economic growth for many years to come (on broad averages). In short, think the Japanese experience of the last 25 years. This is the path that largely the Western Developed world have embarked on.

Balance sheet recessions explained:

- Imagine a small village of 100 people + a bank (as we know them) living in total isolation. One characteristic of this closed economy is that one persons expenses are another persons income.
- Consider the situation where in this small village, debt is increasing every year. As you know (as an individual), you can spend each year as much as you earn each year + your additional borrowings each year.
- So in a period when debt has been rising, the total income in this town would be higher than it otherwise would be. (I.e period of higher GDP)
- and in a period where debt is falling, the total income in this town would be lower than it otherwise would be.

So now let me relate that to the current situation in economies like in much of the western developed world.

- In recent decades, rising debt levels have been thus "artificially" boosting GDP growth.
- In a lot of these countries, debt has risen to a historic extreme where the debt levels may be unsustainable. What are the choices from such a point?
  - First, you can reach a point where lenders refuse to lend any more money (think Greece) ... thus withdrawing the supercharging stimulus to your economy. That is, GDP growth of previous decades cannot be sustained even if high debt levels are sustained.
  - Debtors can reduce spending so they can start saving so they can start paying down their debt. This causes ongoing GDP growth levels to fall even further, potentially pushing these economies into declining GDP levels (recession).
    - Consider the austerity measures imposed by the Eurozone on its highly indebted members over the last 5 years. Indebted countries may be forced to start paying back their debt.
  - Debtors can default, an event which can cause loss of capital by lenders. If defaults are too high you can get a financial collapse like in the Great Depression ... or even a

financial system collapse.

Let us also observe that, as with an individual with very high debt levels, highly indebted countries face a high risk of financial crisis as we saw in the 2008 global financial crisis. This is why the Bank of International Settlements (BIS) is telling central bankers (and their governments) to get their debt levels down... or in BIS's words, *"to repair their balance sheets"* because if they don't more crises can be expected to follow. What BIS have correctly identified, is that that:

- *'Balance sheet recessions differ from typical post-war recessions, which were commonly triggered by a monetary policy tightening to staunch rising inflation. They (balance sheet recessions) are often associated with permanent output losses and protracted stagnation. These unwelcome features arguably result from a combination of four factors: unsustainable output growth during the preceding financial boom, the misallocation of resources during that phase, the headwinds of the subsequent debt and capital stock overhangs, and the associated disruptions to financial intermediation.'*

So let us step through some of the choices for governments, economies and the people in those economies.

- Start paying down debt and accept lower growth rates (and more regular recessions).
- Default. This can happen on a range of levels:
  - A government can default on all or part of its debt (government bonds). Argentina partially defaulted on their bonds in 2002.
  - In a banking crisis:
    - Banks can default on its bonds
    - Banks can force bank hybrids to convert to ordinary shares.
    - Even bank depositors can be forced to take some losses as we saw recently in Cyprus. BIS now recommends that once the first of the above have been used up that depositors should take some losses as part of a bank rescue.

However. The other measures that governments and central banks can employ include:

- **Financial repression.** As Rogoff & Reinhart (***"This Time Is Different: Eight Centuries of Financial Folly"***) pointed out in their book (where they studied the last few hundred years of economic crises), indebted governments tend to try to cheat by employing financial repression which involved:
  - Keeping real interest rates below the inflation rate (like you see now) – which basically is stealing off savers to help pay off debt AND these same measures also tend to create inflation – which is also part of the strategy – because through inflation, they can reduce the debt in real terms, making it easier to pay off.
  - Financial repression is what we have seen in the West since the Global Financial Crisis, and because the mountain of record Western debt is likely to take a few decades to work off, financial repression is likely to continue for many years to come in the West.
- Policy measures to increase productivity... which increases profits + wages in the economy, providing more income to make it easier to pay down debt.
- Invest in infrastructures that delivers a good return on investment (ROI) to the economy.

Related issues:

- Maintaining extreme levels of debt in an economy runs the high risk of a further financial crisis. In addition, maintaining high levels of debt in the economy risks a Minsky moment. http://en.wikipedia.org/wiki/Minsky_moment
  - *'A Minsky moment is a sudden major collapse of asset values which is part of the credit*

cycle or business cycle. Such moments occur because long periods of prosperity and increasing value of investments lead to increasing speculation using borrowed money. The spiraling debt incurred in financing speculative investments leads to cash flow problems for investors. The cash generated by their assets no longer is sufficient to pay off the debt they took on to acquire them. Losses on such speculative assets prompt lenders to call in their loans. This is likely to lead to a collapse of asset values. Meanwhile, the over-indebted investors are forced to sell even their less-speculative positions to make good on their loans. However, at this point no counterparty can be found to bid at the high asking prices previously quoted. This starts a major sell-off, leading to a sudden and precipitous collapse in market-clearing asset prices, a sharp drop in market liquidity, and a severe demand for cash.'

- Paying down debt by saving more is a necessary part of the solution .... and this necessarily drags on medium-term growth levels. BIS talks of 15-20 years being the typical period of sub-trend GDP growth rates while balance sheet repair occurs, for atypical balance sheet recession. However, given the historic extreme nature of Western debt bubbles, it is easy to envisage that sub-trend GDP growth is likely to continue in many Western countries for much longer than 20 years (post GFC).