The case for “Risk of deflationary crash”.

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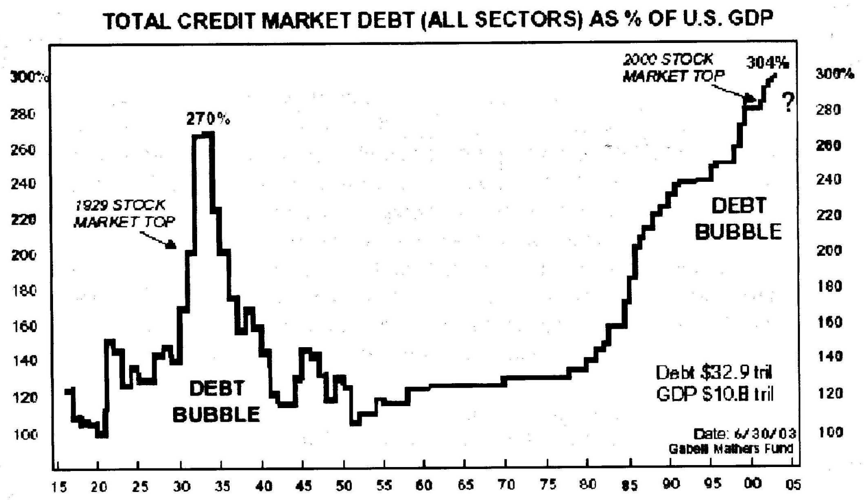
Perhaps our biggest risk this decade, relates to the historically large credit bubble that we are now experiencing characterised by the US graph below. However, this is a phenomena in the Western developed world – including Australia.

The worrying aspect of this credit bubble, is that when large credit bubbles have burst in USA and Australia over the last 180 years, the economy slumped into depression. Prechter provides a very rational, logical explanation of the mechanisms that cause this to occur – and why the central banks become powerless to stop it once the credit bubble deflation has gained momentum.

So what value has Robert Prechter's book provided:

1. He draws our attention to the risks posed by a credit bubble,
2. He shows us that we (at least the USA) are in one of the two large credit bubbles experienced over the last century, and that the credit bubble we are now in is by far the biggest - and that the previous one started bursting in 1929 as the world descended into the great depression.
3. Prechter also describes in detail, the mechanics of the deflation of credit bubbles - which will be helpful to help us understand what might be happening in the period ahead.



Includes Public & Private Debt

You will know from May 24th 2004 Four Corners that Australia has the second highest personal debt per person in the western developed world. So Australia also is in the same credit bubble as the USA is now.

Prechter then asserts (approx) that all credit bubbles that have occurred in the USA over the last 2 centuries have resulted in depressions. This focused my mind on doing a little more research on past credit bubbles. The following is some extra information on credit bubbles in Australia and USA over the last 2 centuries.

A) From Russell Napier, "Inflation through Deflation" January 2003. Discussing Australia's 1880s credit bubble, unique in the western world, and which preceded our depression in the 1890s. Some material from Russell Napier appears below.

B) Credit analyst Hamilton Bolton's writings 1960, looking at credit bubbles 1820-1960 in USA. Hamilton identified that previous to 1929, USA did not have a credit bubble of similar magnitude between 1835 and 1929 except for the 1830s. The collapse of this credit bubble resulted in a bear market in US shares from 1836 to 1857. (21 years).

Side note: Hamilton's paper also provides a very enlightening insight into why in the 1800s, the US share market oscillated between short bull markets and long bear markets - and why the 1900s was the reverse. This was basically because of the way the economy was managed. These same changes also have directly caused the 1900s have much higher inflation (on average) than the 1800s.

Marc Faber support's Bolton's reference to depression in 1837 as follows: *"All American banks had to suspend specie payments and between 1837 and 1839 over 1500 banks failed. .. By the fall of 1837, nine-tenths of Eastern Factories closed. The 1837-41 'Hard Times Depression' was extremely severe"*.

Bottom line: I believe these sources, support the case to be concerned that the credit bubble is one of our biggest investment risks for the coming decade.

From Russell Napier – about the Australian experience 1880s & 1890s

"**From 1870 to 1888 Australia bucked the global deflationary trend.**

There is one feature of late 19th century Australia which makes it stand out from the rest of the world- prices. Australia was one of the few places in the world to avoid the deflationary trends in the global economy evident from 1870. According to estimates by NG Butlin, Australian Domestic Product, Investment and Foreign Borrowing 1861-1839 (1962), retail prices rose 16% from 1870 to 1886. House rents in Australia increased by 22% over the same period. Wages in New South Wales rose 22% over the same period. This inflation in wages, rents and retail prices occurred despite a collapse in commodity prices in Australia.

Why the discrepancy between Australia and the rest of the world?
One of the key factors was the boom in financial institutions in Australia which resulted in an ever higher mountain of credit being built on the foundation of the gold currency. From 1871 to 1891 the assets of Australian financial institutions increased six-fold.

This six fold rise in assets occurred during a period when the amount of currency increased 85%. **Australia bucked the deflationary trend but only at the cost of a credit mountain** which ultimately collapsed in the 1890s. The **1890s recession was the worst ever experienced in Australia** and real GDP did not surpass its 1891 level until 1898.

Twelve years after the economic peak of 1889 GDP per capita was still 17% below its peak level! So while there may be few lessons for Australia from the long boom there may be an important warning for the world. The bankers who see ever lower interest rates as a sign of improved ability to service credit may in fact be looking at the signal of an impending deflation. **The credit mountain postponed the deflationary forces for almost twenty years in Australia by inflating property prices however when deflation arrived it devastated the economy because, more than in other countries in the world, it devastated the financial system.**

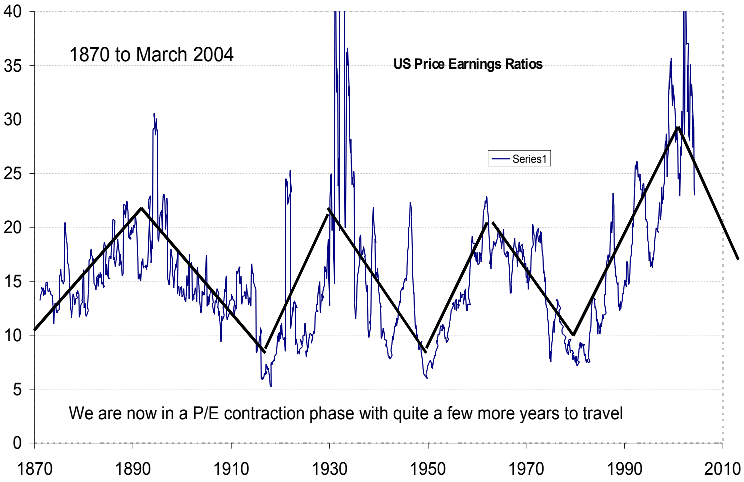
For the one country where credit excesses offset the deflationary momentum (1870-1888) a truly massive property price crunch followed. **Have the central bankers of the developed world created a similar dynamic in their attempt to ward off the prospect of imported deflation?"**

Why can crashing credit bubbles cause depressions?

In brief, Prechter argues along these lines:

❒ That a growing credit bubble is coincident with growing optimism (and reduced understanding and perception of risk)

❒ That through history we see that optimism travels in cycles – as investors, consumers and corporates move from periods of excess pessimism to periods of excess optimism and back again. In a simplistic manner we can see these cycles reflected in historical Price/Earnings ratio charts.



❒ That now, after such a long, economically-rosy period, investors and consumers are still near a peak in optimism – and as a result are borrowing excessively, oblivious to the risks to themselves that this might posed to their financial security.

❒ That at some point, a trigger event leads to the beginning of the deflation of the credit bubble. This might be:

➔a share market crash that might cause people to make serious losses – shocking people into understanding that they have been living beyond their means and that they have been taking excessive risks. This then can lead to these investors into

1. consuming less. If a lost of consumers start consuming less and saving more, this leads to lower sales for suppliers of goods and services, leading to lower profits
   - ➢ leading to falls in the value of the companies stock, leading more investors to become less optimistic ... and this cycle keeps flowing on ...
   - ➢ lower company profits can then lead to retrenchment of staff. Higher unemployment then leads to lower consumption, lower corporate sales, lower corporate profits ... and this cycle keeps flowing on....
2. borrowing less & winding back their debt possibly including sales of assets. As people dispose of assets, the growing selling pressure in the markets puts downward pressure on prices, making more and more investors more and more pessimistic and more and more investors realise bigger and bigger losses on their investments ... and this cycle keeps flowing on ...

➔As pessimism takes hold, banks also become pessimistic, and increasingly refuse to lend for fear of defaults. So the banking system also becomes "part of the problem."

Regardless of what the trigger event is to start the deflation of the credit bubble, once it starts it can rapidly become a self-feeding cycle – sometimes called "the vicious cycle." If you like this is the equal and opposite to what we saw in the 1990s in USA, where the reverse self-feeding cycle was often labelled the "virtuous cycle."

Can a central bank stop a huge credit bubble crashing?

In short NO. Prechter provides a clear and logical discussion of why. In short it is because the central banks main tool to manage the economy, is its ability to help manage the money supply. The central banks can:

❒ "apply the brakes" on the economy by raising interest rates, reducing the ability and willingness of people (investors/consumers/corporates) to borrow.

❒ "press on the accelerator" by lowering interest rates, increasing the incentive to borrow – and increasing the attractiveness of borrowing.

In short the central banks main tool, is to manage the attractiveness of credit.

The difficulty is, that when pessimism becomes strong, people (investors/consumers/corporates) won't borrow even when interest rates are cut to virtually NIL. Japan's experience in the 1990s demonstrates this clearly.

In summary, central banks cannot stop the credit bubble from crashing because they cannot force pessimistic people to borrow.

Is it different this time?

I have often heard this said. The argument is that:
❒ We are smarter now or
❒ We have learned from the past or
❒ We now have mechanisms in place (post 1930) to prevent this ever occurring again.

Yes, the world is different now. And various mechanisms were put in place after 1930.

But people are still the same . People still behave the same way now that they did 100 years ago. People still become optimistic and pessimistic – greedy and fearful. It is the behaviour of people which causes credit bubbles to burst – and unpleasant consequences to follow. However, because the driver of all this is the emotional behaviour of people, it is very difficult to predict either
❒ when the credit bubble will burst
❒ with any precision, the course of events bursting the bursting of the bubble
❒ how serious an economic event might be caused by the bursting credit bubble.
However, is clear that the bigger the credit bubble, the greater the risk.

Interestingly as well, over the last 30 years, the USA has been increasingly dismantling protection mechanisms put in place post 1930. Mmm.

What can we learn from Japan's experience?

Japan's experience after their 1989 share market crash may demonstrate that a credit bubble crash can be different from the experience of USA and Australia. Japan had a credit bubble in the 1980s – but they did not have a depression in the 1990s. Yes, they had a stagnant economy for 14 years following the 1989 share and property market crash – and they did drift into recession and deflation a number of times during that 14 year period. But it was clearly not a depression.

A key reason why Japan avoided depression might have been because they did not let a lot of companies go bankrupt. They allowed a lot of bad debts to stay in the system rather than driving companies into bankruptcy. This bad debt problem has clearly made it a lot more difficult to get Japan back to resilient healthy economic growth – but they have avoided a depression.

By contrast, the way of things in the USA, is that you let companies go bankrupt. This means that the excesses can be cleaned out of the system much quicker than occurred in Japan – and therefore the economy can get back to stronger healthy growth more quickly. However, the people-cost & disruption can be high.

If you could choose between going through a period like Japan in the 1990s and USA in the 1930s, which would you choose?