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# Balance sheet recession is the reason for secular stagnation

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*The Great Recession is often compared to Japan's stagnation since 1990 and the Great Depression of the 1930s. This chapter argues that the key feature of these episodes is the bursting of a debt-financed asset bubble, and that such 'balance sheet recessions' take a long time to recover from. There is no need to suffer secular stagnation if the government offsets private sector deleveraging with fiscal stimulus. However, until the general public understands the fallacy of composition, democracies will struggle to implement such policies during balance sheet recessions.*

With the developed economies failing to regain forward momentum after six years of zero interest rates, people are beginning to worry that they may be facing secular stagnation. Although this is an understandable reaction, a large part of the stagnation may be due to the balance sheet recession that these economies are all facing after the bursting of their debt-financed asset price bubbles. And this type of recession takes a long time to overcome, for both economic and political reasons.

## **The mechanics of balance sheet recession**

On the economic front, when a debt-financed bubble bursts, a large number of businesses and households realise that the liabilities they incurred during the bubble days are still on their books, while the assets they bought with borrowed funds have collapsed in value, leaving their balance sheets deep underwater. In order to climb out of their negative equity territory, they have no choice but to pay down debt with their

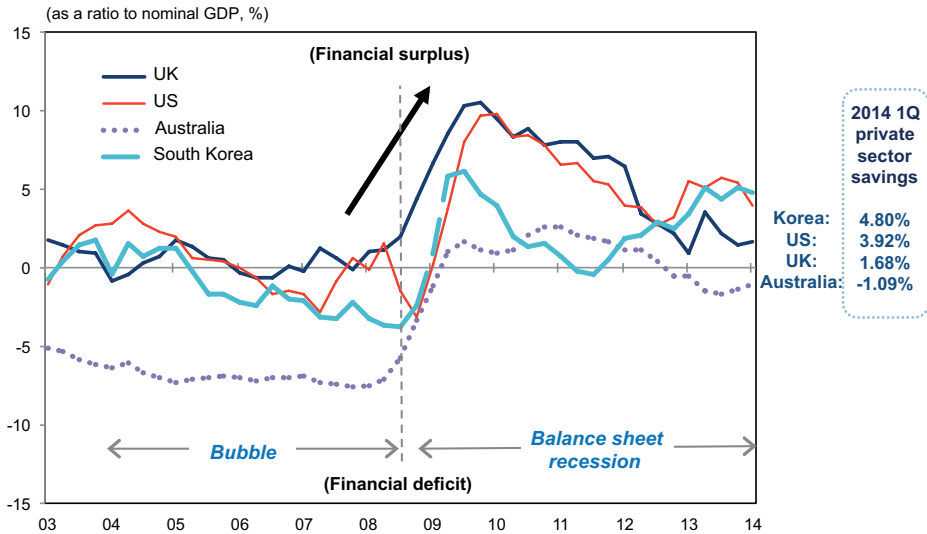
cash flow as quickly and quietly as possible. In other words, they are minimising debt instead of maximising profits.

Although this is the right thing to do for individual businesses and households, when everybody does it at the same time the economy falls into a massive fallacy of composition problems. This is because in a national economy, if someone is saving money or paying down debt, someone else must be borrowing and spending the same amount for the economy to move forward.

In the usual economy that task is borne by the financial sector, which has the incentive to lend or invest all the funds entrusted to it in order to maximise profits. And the usual mechanism to make sure that all saved funds are borrowed and spent is the interest rate; when there are too many borrowers, interest rates are raised and when there are too few rates are lowered.

But after the bursting of a nationwide asset price bubble, those with balance sheets under water are not interested in increasing borrowing at any interest rate. There will not be many lenders either, especially when the lenders themselves have balance sheet problems. The lack of borrowers means a significant portion of the newly saved and deleveraged funds that are entrusted to the financial sector are unable to re-enter the real economy. This in turn means that those unborrowed savings become a leakage in the income stream and a deflationary gap for the economy. If left unattended, this deflationary gap will push the economy ever deeper into balance sheet recession, a highly unusual recession that happens only after the bursting of a nationwide asset price bubble.

**Figure 1** The US, UK, South Korean & Australian private sectors are deleveraging after the bubble<sup>1,2</sup>

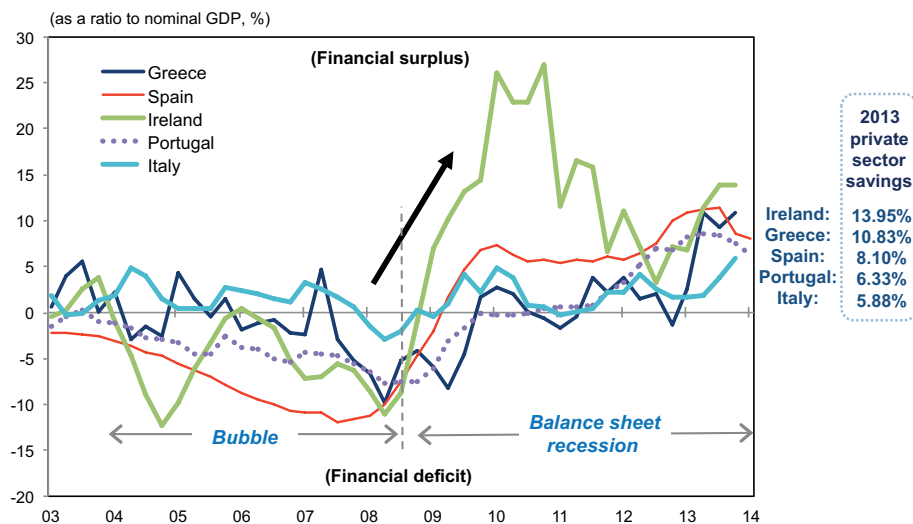


Notes: 1. Private Sector = Household Sector + Non-Financial Corporate Sector + Financial Sector. 2. All entries are four-quarter moving averages. For the latest figures, four-quarter averages ending in 1Q/14 are used.

Sources: Office for National Statistics, UK, FRB, Australian Bureau of Statistics and Bank of Korea.

The flow of funds data for the developed countries that experienced housing bubbles until 2008 indicate that, except for Australia, their private sectors are all in financial surplus, i.e. they are either saving money or paying down debt (Figures 1 and 2). The fact that they are saving money or paying down debt instead of borrowing at zero interest rates means the private sectors of all of these countries are facing severe balance sheet challenges. The same pattern is observed in the private sectors in Japan after the bursting of its massive real estate and equity bubbles in 1990 and in Germany after the bursting of its telecom bubble in 2000 (Figure 3).

**Figure 2** Eurozone private sectors are deleveraging massively after the bubble<sup>1,2</sup>



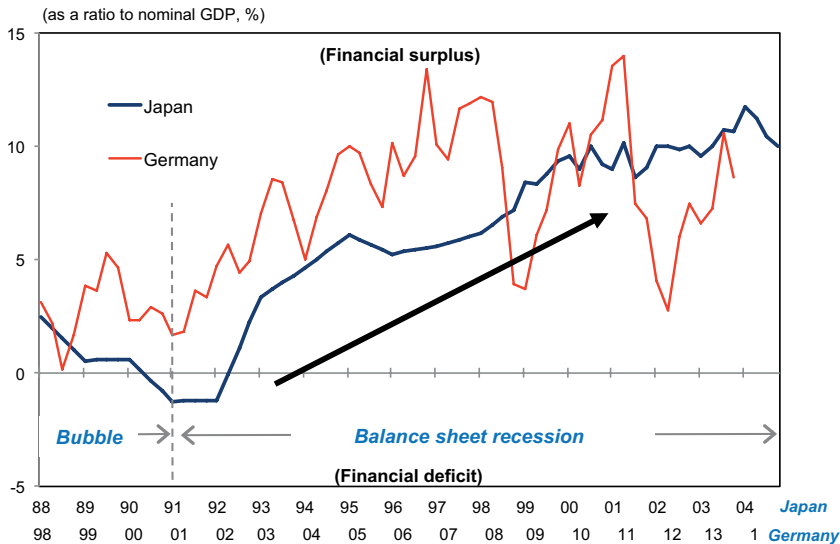
Notes: 1. Private Sector = Household Sector + Non-Financial Corporate Sector + Financial Sector. 2. All entries are four-quarter moving averages. For the latest figures, four-quarter averages ending in 4Q/13 are used for Ireland, Greece and Italy, and those ending in 1Q/14 are used for Spain and Portugal.

Sources: Bank of Greece, Banco de España, National Statistics Institute, Spain, The Central Bank of Ireland, Central Statistics Office Ireland, Banco de Portugal, Banca d'Italia and Italian National Institute of Statistics.

During this type of recession, monetary policy is largely ineffective because, as stated earlier, those with balance sheets under water will not increase borrowing at any interest rate, and financial institutions are also not allowed to lend to those borrowers with balance sheets under water. In addition, the government cannot tell the private sector not to repair its balance sheets because the private sector has no choice but to put its financial houses in order.

This means the only thing the government can do to offset the deflationary forces coming from private sector deleveraging is to do the opposite of the private sector, i.e. borrow and spend the unborrowed savings in the private sector. In other words, fiscal stimulus becomes absolutely essential during this type of recession.

**Figure 3** The Japanese and German private sectors also deleveraged after their bubbles<sup>1,2</sup>



Notes: 1. Private Sector = Household Sector + Non-Financial Corporate Sector + Financial Sector. 2. All entries are four-quarter moving averages. The latest figure for Germany is four-quarter moving average ending in 4Q/13.

Sources: Bank of Japan, Cabinet Office, Japan, Bundesbank and Eurostat.

If the government promptly borrowed and spent the unborrowed savings in the private sector, there would be no leakage in the income stream and the GDP level will be maintained. If the GDP level is maintained, the private sector will have the income to pay down debt. Since asset prices will not fall below zero, as long as the private sector has the income to pay down debt, the balance sheet problem will eventually be resolved.

This also means the government must *sustain* the fiscal stimulus for years until the private sector has finished repairing its balance sheets and has become ready to borrow again. Any premature withdrawal of fiscal stimulus would unleash the deflationary forces, as unborrowed savings are allowed to become a leakage in the economy's income stream. Indeed, the US in 1937, Japan in 1997 and the UK and Eurozone in 2010 all experienced serious double-dip recessions when their governments pursued fiscal consolidation while their private sectors were still in the process of repairing balance sheets.

The forward momentum of economies during this period is necessarily weak because a large part of corporate cash flow is directed towards paying down debt instead of towards research and new product development. Even if corporate research departments are coming up with new ideas and products, their management may be unable to put them into production because of the need to first repair their balance sheets. Many Japanese companies lost their lead to foreign competitors during the last 20 years due to this reason.

Many households will also be rebuilding the savings they thought they had prior to the bubble bursting. That means they will be cutting down on purchases of all kinds, but especially those on credit. The fact that the household sectors of virtually all developed countries have become huge net savers after 2008, in spite of record low interest rates, made even those businesses with clean balance sheets extremely cautious to invest in new capacity.

## **Recovery from balance sheet recession takes time**

When the economy is confronting a fallacy of composition problem affecting a large part of society, the burden cannot be easily shifted to another group. If the government decides to waive all debt for insolvent businesses and households, for example, the problem merely shifts to the entities that lent them the money, i.e. banks and depositors. This means the only option is to wait for the whole of society to get better, a process that takes time.

In a balance sheet recession, the affected businesses and households must use fresh *flows* of savings to slowly repair their balance sheets burdened by the *stock* of excessive debt. The greater the damage to balance sheets, the more time it takes to clean them up. For example, if a company has a \$10 million hole in its balance sheet and can generate \$2 million a year in cash flow that can be used to pay down debt, the repair process will take five years.

But as more firms embark on this process and start to use a large part of their free cash flows to pay down debt, the recession worsens, squeezing cash flow and leading to further declines in the asset prices that triggered the recession in the first place. That is why the government – which is outside the fallacy-of-composition problems – has to proactively take the other side of the bet, so to speak, from the private sector and prevent a vicious cycle. If the government makes the mistake of opting for fiscal consolidation too soon, a recession that people expected would end in two or three years – like Japan's in 1997 – may persist for seven years, or even ten.

Even after the balance sheets are repaired, people who were forced to deleverage for an extended period of time tend to experience a kind of debt-related trauma that acts as a psychological block to borrowing, even after they have cleaned up their balance sheets. The Americans who had to pay down debt during the Great Depression – the balance sheet recession par excellence – never borrowed money until they died. Even after US private sector balance sheets were repaired thanks to the astronomical government spending of World War II, it still took until 1959 (i.e. full three decades) for US interest rates to return to the average level of 1920s.

The Japanese finished repairing their corporate balance sheets by 2005, but there is no sign that they are resuming their borrowing in spite of the lowest interest rates in human history and the most willing bankers. And that is true even after one full year of Abenomics, which included massive monetary easing.

## **Democracies are ill-equipped to deal with balance sheet recessions**

On the political front, the unfortunate fact is that democracies are ill-equipped to handle such recessions. For a democracy to function properly, people must act based on a strong sense of personal responsibility and self-reliance. But this principle runs counter to the use of fiscal stimulus, which involves depending on 'big government' and waiting for a recovery. During a balance sheet recession, people with good incomes and sound

balance sheets will vociferously object to fiscal stimulus and with it the implications of big government, especially once they learn that the stimulus will help rescue people and institutions that participated in the bubble.

Moreover, most people are not aware that this kind of recession is triggered by fallacy-of-composition problems that occur when individual businesses and households begin doing the right and responsible thing by repairing their balance sheets. When the government tries to administer fiscal stimulus, the media, pundits and ordinary citizens who do not understand balance sheet recessions are quick to argue that politicians are wasting taxpayers' money on useless projects to win re-election.

For the past 20 years, the Japanese media and orthodox academics have self-righteously and almost reflexively equated fiscal stimulus with pork-barrel politics. In the US, members of the Tea Party, the Republican Party splinter group that has become so influential, have effectively staked their political careers on preventing the federal government from undertaking fiscal stimulus. German Chancellor Angela Merkel's decision to force through a fiscal compact calling on all Eurozone countries to follow Germany's example and pursue fiscal consolidation was based on a similar philosophy. Since these people were never exposed to the concept of balance sheet recession at university, it is difficult to convince them of the need for fiscal stimulus to cure a disease they have never heard of.

The point is that it is almost impossible to maintain fiscal stimulus in a democracy during peacetime. It is difficult in a democracy because such policies cannot be implemented and maintained during peacetime unless millions of people are persuaded of the need for fiscal stimulus. In contrast, in an autocratic state, only one person – the dictator – needs to be persuaded in order to both administer and maintain fiscal stimulus.

It is difficult in peacetime because during war, when a nation's survival is at stake, no one complains about government spending on armaments or air-raid shelters. There is no danger of getting bogged down in endless debates over how to spend the money, because the answer to that question during wartime is clear to all involved.



Adolf Hitler and Franklin Roosevelt were both elected in 1933 when Germany and the US were in severe balance sheet recessions. The German unemployment rate reached 28% that year and US rate was not far behind at 25%. Although both started with fiscal stimulus, Roosevelt, worried about the criticisms from deficit hawks, reversed course in 1937, resulting in a serious double-dip recession and the unemployment rate increasing to nearly 20% again. Hitler, on the other hand, stayed the course and by 1938, German unemployment had fallen to 2%. And nothing is worse than a dictator with a wrong agenda having the right economic policy, especially when the democracies around him are held hostage to the orthodoxy and remain unable to adopt correct policies.

More recently, the Chinese government implemented a 4 trillion renminbi fiscal stimulus in November 2008 when it was facing a sharp fall in both domestic asset prices and exports. As a percentage of GDP, the stimulus was more than double the size of President Obama's \$787 billion package unleashed three months later. At the time, western observers were laughing when the Chinese government announced that they are going to maintain 8% growth. China's growth soon reached 12%, and nobody was laughing.

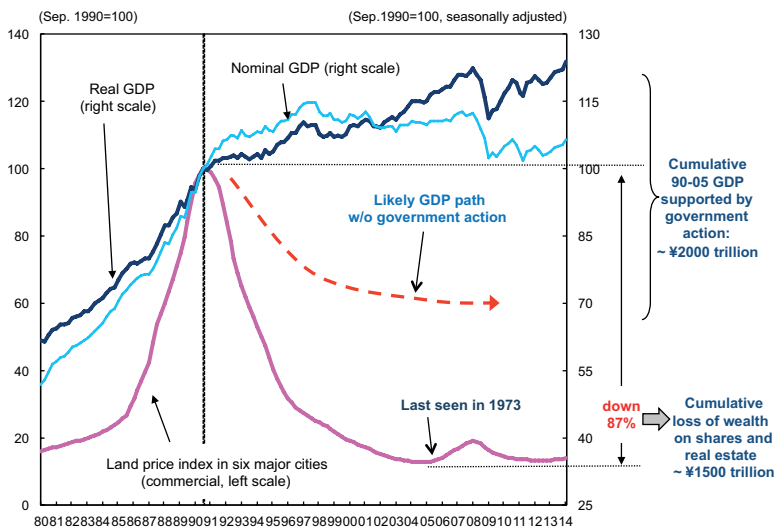
The US government, on the other hand, was extremely cautious with its fiscal stimulus because of the fear that the stimulus package might be criticised for wasting money. As a result, it could not offer the kind of positive jolt its designers have hoped for. The Obama Administration's inability to renew the fiscal stimulus package due to Republican opposition slowed down the subsequent US recovery in no small way.

It is actually not difficult to implement fiscal stimulus when a country experiences a major shock (like the Lehman failure and the Global Crisis). The challenge is whether it can be kept in place long enough for the private sector to finish repairing balance sheets.

At the emergency G20 meeting held in Washington two months after Lehman Brothers collapsed, the 20 nations agreed to administer a dose of fiscal stimulus – a decision attributable in no small part to the efforts of Japanese Prime Minister Taro Aso. Formerly

a corporate executive, Aso was one of the few Japanese politicians who understood that fiscal stimulus was the key to maintaining Japanese GDP when the private sector was saving 8% of GDP at zero interest rates. And at the G20 meeting, he used Figure 4 to tell the leaders of the other 19 countries that Japan was able to maintain its GDP at above the bubble peak for the entire post-bubble period with fiscal stimulus, in spite of commercial real estate prices falling 87% from the peak to the level of 1973.

**Figure 4** Japan's GDP grew despite major loss of wealth and private sector deleveraging



Sources: Cabinet Office, Japan Real Estate Institute

The G20 ultimately agreed to administer fiscal stimulus in 2009, and the global economy staged a V-shaped recovery instead of falling into a depression, as had been feared. But as soon as the economy started to show signs of life, deficit hawks took over the policy debate.

## **Those who prevent crises never become heroes**

It is often said that people who prevent crises never become heroes. Hollywood teaches us that for there to be a hero there must first be a crisis, and the experience of Prime Ministers Taro Aso and Gordon Brown bears that out.

The Japanese media, for example, completely missed the significance of Aso's contribution at G20 in November 2009. Instead, they tried to portray his administration as a care-taker government ahead of the general election scheduled for 2009, and devoted a great deal of coverage to the prime minister's misreading of a single Chinese character in one speech. Partly as a result of such publicity, the LDP was defeated in the election held in August 2009. The UK Prime Minister Gordon Brown, another leader who understood what a balance sheet recession was and used fiscal stimulus to address it, was also defeated in his quest for re-election.

At the Toronto Summit in 2010 – with both Aso and Brown, who had *prevented* crises, out of the picture – the G20 leaders agreed on a plan to halve their fiscal deficits in three years. This in spite of the fact that the private sectors in these countries continued to save massively despite near zero interest rates.

The resulting fiscal retrenchment sent the developed economies into reverse, with the UK and many parts of the Eurozone falling into double-dip recessions. Japan, under the new DPJ government that understood nothing of balance sheet recessions, also stagnated.

In the US, however, Federal Reserve Chairman Ben Bernanke and others soon realised that the Toronto agreement had been a mistake. They kept the US from pursuing premature fiscal consolidation by issuing the warning with the expression 'fiscal cliff', thereby making it the first country to renege on the agreement. Consequently, the US – alone among the developed economies – continued to post modest economic growth, while Japan, the UK, and continental Europe faced severe economic weakness.

Partly because of subsequent reflection on this error, the pendulum had swung back towards the recognition of the importance of fiscal stimulus by the time the St. Petersburg G20 Summit was held in 2013. Although the three years following the Toronto Summit were completely wasted from a global economic perspective, at least there has been some recognition among policymakers that fiscal stimulus is important in this type of recessions. The risk remains, however, that this will turn out to be just another phase in an on/off cycle of fiscal stimulus in democracies during peace time.

The above examples show that there is no need to suffer ‘secular stagnation’ if proper policies are put in place, but that democracies are very bad at implementing such policies during balance sheet recessions. This predicament will stay with democracies until the general public (the millions) is made aware of the disease called balance sheet recession and how to cure it. Until then, the far-from-ideal on/off cycle of fiscal stimulus and the resultant delayed recovery will make people feel like they are in secular stagnation.