Divergences, debt and economics

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At the beginning of this year, there was much talk of global economic and policy divergences and the implications of this for market outcomes in the year ahead. The widespread consensus was that the US Economy would experience particularly healthy economic growth (at least 2.5% to 3% per annum) with interest rates rises expected mid-year along with a strong US dollar. In contrast, economic growth in most other countries was expected to be minimal or slowing, with monetary policy at least on hold or with an easing bias.

In the months since it has become clear that economists significantly underestimated the breadth and extent of monetary easing that would occur in early 2015, with around 30 central banks already announcing cuts in interest rates and the ECB beginning a major bond buying program. Interest rates have gone negative in some jurisdictions. Concerns regarding sluggish economic growth and deflation risks abound.

At least economists had the general direction towards more easing right. In contrast, the far bigger surprise so far in 2015 has been the lack of growth in the US, the year's supposed economic growth engine. When the initial first quarter GDP for the US came out at just 0.2% annualised - disappointing even reduced estimates of 1% annualised - it became clear slow or slowing growth is a problem everywhere. The big "divergence" was not the growth rate between economies but between economists' forecasts and outcomes.

Of course, some have blamed temporary effects such as weather and they could well turn out to be right. After its latest meeting in late April, even the US Federal Reserve described the Q1 weakness as temporary. However, economists have been continually disappointed with the slow pace of the economic recovery in the US for the majority of the recovery period since 2009. Further, the Fed's longer term economic predictions have hardly been much better than the over-optimistic private consensus. Finally, given the Fed is under increasing pressure to take at least some steps towards monetary policy normalisation, it is hardly in its interest to paint the current slowdown as anything other than temporary, at least until evidence clearly proves otherwise.

Of course, it’s not as if these negative surprises on economic growth have been bad for financial markets in recent years. Indeed, the predominant meme is "bad news is good news" because financial markets expect central banks to step in with further monetary policy easing measures whenever there is economic weakness. However, with interest rates close to zero and financial market valuations already elevated, perhaps we are moving closer to a point where bad news may be seen as bad news again. This could reflect an increasingly

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overdue loss of faith that central banks have all the appropriate tools for igniting and maintaining robust economic growth.

Perhaps one of the major reasons we remain in a period where economic growth remains so challenged, particularly in the western world, is because we are coming off a multi-decade period where there was rapid build-up of debt at many levels. While debt growth has slowed somewhat, it has done so at record levels compared to history. As illustrated by the McKinsey & Company Report from February 2015 "Debt and (not much) Deleveraging" debt has continued to expand in nearly all countries, in both absolute and relative to GDP terms.

On the one hand, extreme central bank action during and after the Global Financial Crisis precluded any pronounced and widespread deleveraging that would have cleansed the system and set the foundation for more robust growth in the recovery years (along with strong but sensible growth of debt from a lower base). The normal creative destruction process was short circuited in an effort to avoid a re-run of the Great Depression. While there was some significant de-leveraging in the financial sector and initial de-leveraging in the US household sector due to mortgage defaults, debt in the real economy - household, corporate, government - has continued to rise, albeit at a more gradual pace (other than in China and developing economies). As a result, the average total level of debt as a percentage of national income has risen in almost all developed economies since the eve of the GFC.

On the other hand, despite the efforts of central banks and an extremely accommodative monetary environment, this credit growth has been tepid and has had limited success in igniting a higher level of economic activity. Post-GFC, cautious consumers and businesses contemplating their already heavy debt burdens have been more reluctant to borrow to spend and invest (excluding some specific sectors such as Sydney and Melbourne residential property). When debt is only expanding slowly and from already high levels, it can be a major drag on growth because of debt costs (even at low interest rates) and because consumers and businesses are much more cautious about their financial situation.

Is it therefore any surprise then that we have reached a point where further cuts in interest rates are failing to stimulate further borrowing and spending to the same degree as they have in the past? Yet it seems central banks and governments continue to rely on lowering interest rates with the aim of encouraging households and corporates to take on more debt on top of the excessive levels already held. (In this context maybe Joe Hockey's "Have a Go" budget deserves more credit, even if it risks greater government debt).

The key beneficiaries of these extremely accommodative monetary policies have been booming financial markets and the wealthy minority who have most exposure to financial and other assets (e.g. property) that benefit from low interest rates. They are also the part of the population which often has the least marginal propensity to consume this additional wealth.

Of course, part of the rationale for maintaining very low nominal and negative real interest rates (so called financial repression) is to allow an extended period of time where the

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economy can grow faster in nominal terms than the debt burden. However, this debt remedy is undermined if financial repression encourages households and corporates or governments to resist paying back debt or even pile on more debt. Are today's near zero and record low interest rates simply allowing what would otherwise be insolvent households, corporates and even governments to avoid adjusting to a more realistic world of more normal interest rates? Is this repression worth the distortions to the sensible allocation of capital and constraints on economic growth it seems to be causing?

So where to from here? Have we reached debt saturation and an endgame? Will all this debt ever be repaid? Does it matter anyway for the global economy since all the debt itself is always owned by other participants in the economic system (although, scarily, central banks themselves hold more than through any other point in history)? Is the increase in debt since the GFC just another (slower) leg up in an increasingly indebted world? Why should we be at a limit here?

Perhaps the current extremely easy monetary policies will eventually succeed in driving a faster acceleration of credit growth along with improved economic growth, at least temporarily, as the current caution amongst business and households fades. But will this just be paving the way for an even bigger debt crisis down the road? The McKinsey Report expresses doubt that countries with non-financial debt that is equivalent to three to four times GDP will be able to grow themselves out of debt, even at current low interest rates.

In a world dependent on robust economic growth to solve or postpone debt problems the over-reliance on an apparently slowing US economy is of major concern. Perhaps policy makers need to stand back and better examine the current and potential consequences of their actions in the context of the dynamics of debt over multi-decade periods. A problem with the McKinsey study is that it focuses only on the period since 2000 (and some of it since 2007) whereas the global debt build-up looks even more epic and dangerous when one realise it commenced much earlier - in the 1980s (some say 1970s for the US) following financial deregulation. The ultimate debt unwind, whenever it comes, is likely to be equally epic, if over a much smaller time scale.

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