Debtonation?

Replacing government money creation with inadequate private debt expansion is a danger that could explode the economy

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by

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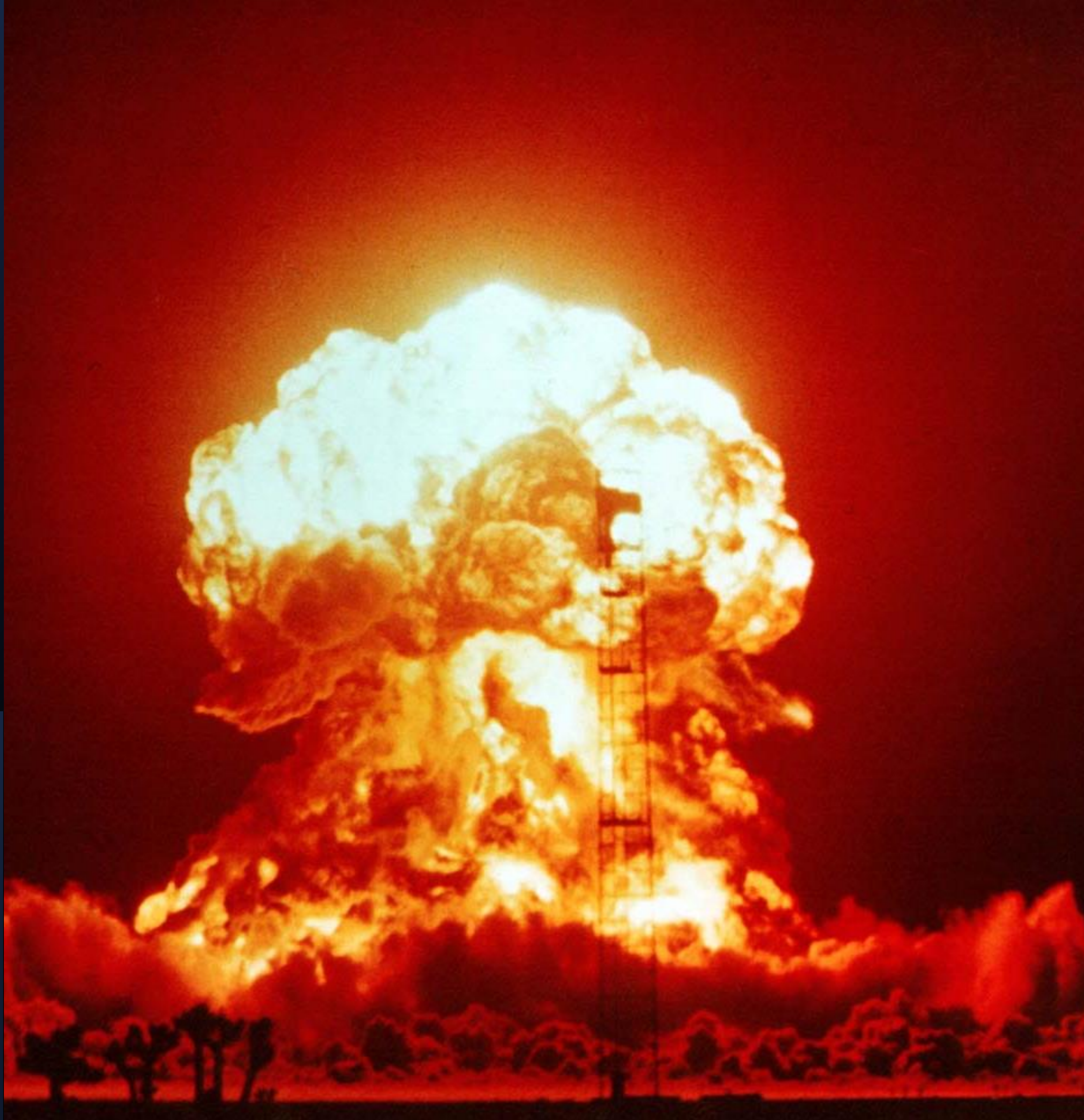
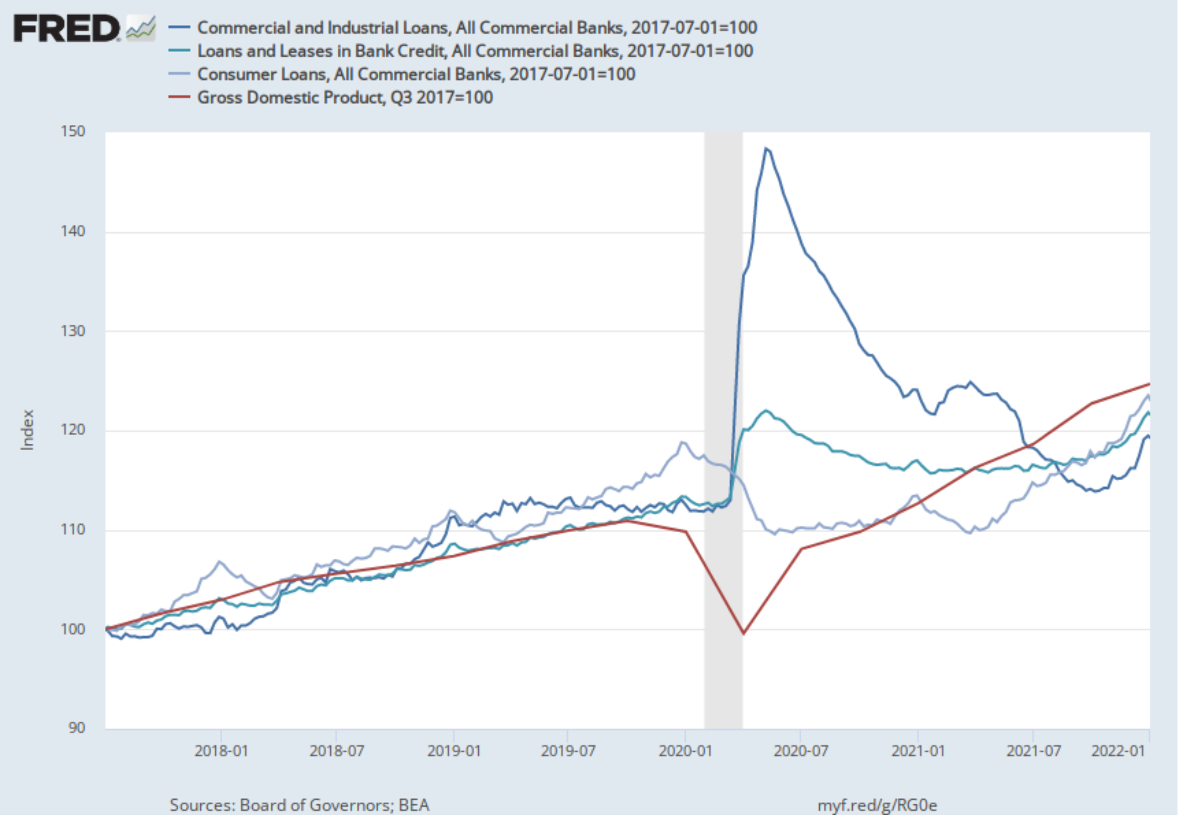
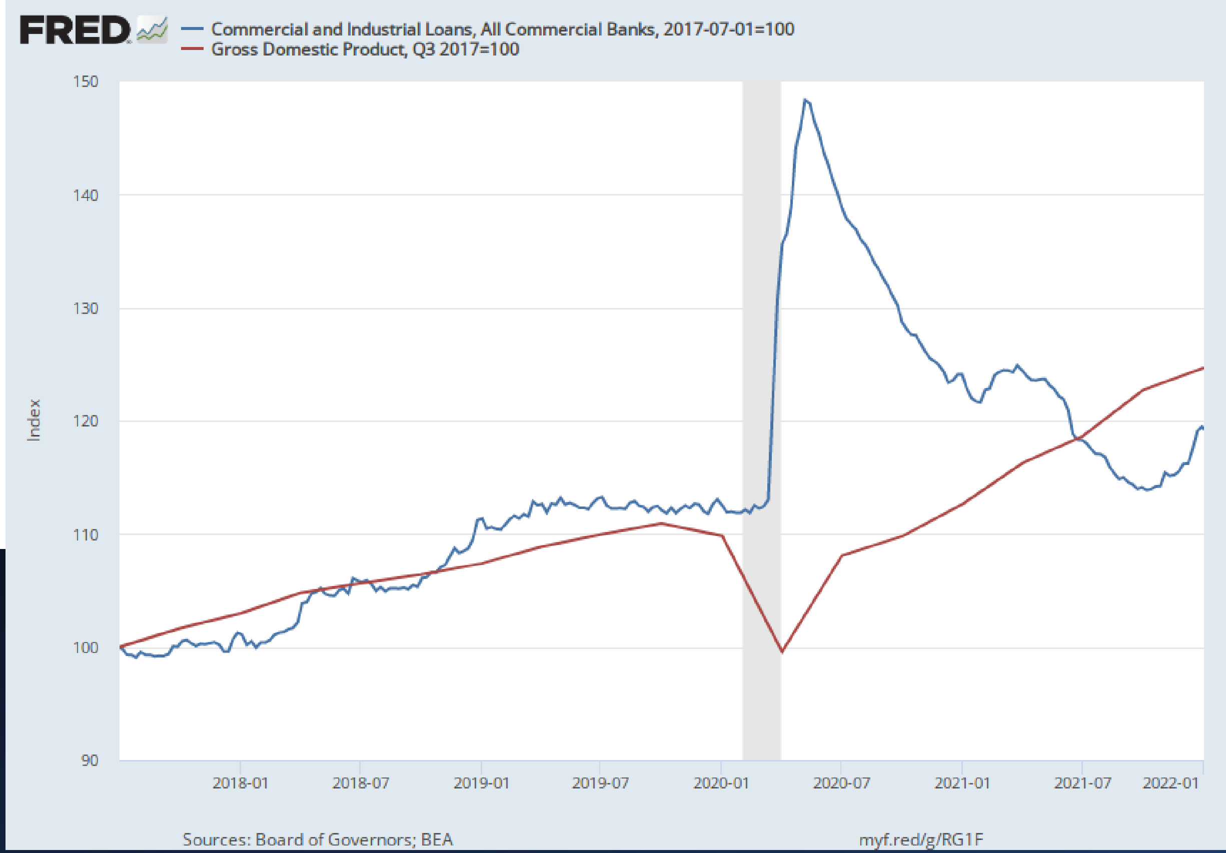


Debtonation?

Total US borrowing – the teal coloured line generally in the middle of the outlying lines – has, during the last 5 years and prior to that, grown roughly in line with the growth in economic activity (the maroon line) although there was a significant temporary divergence during lockdown until the lines briefly intersected again, crossing at the end of Q1 last year.



What does that mean?

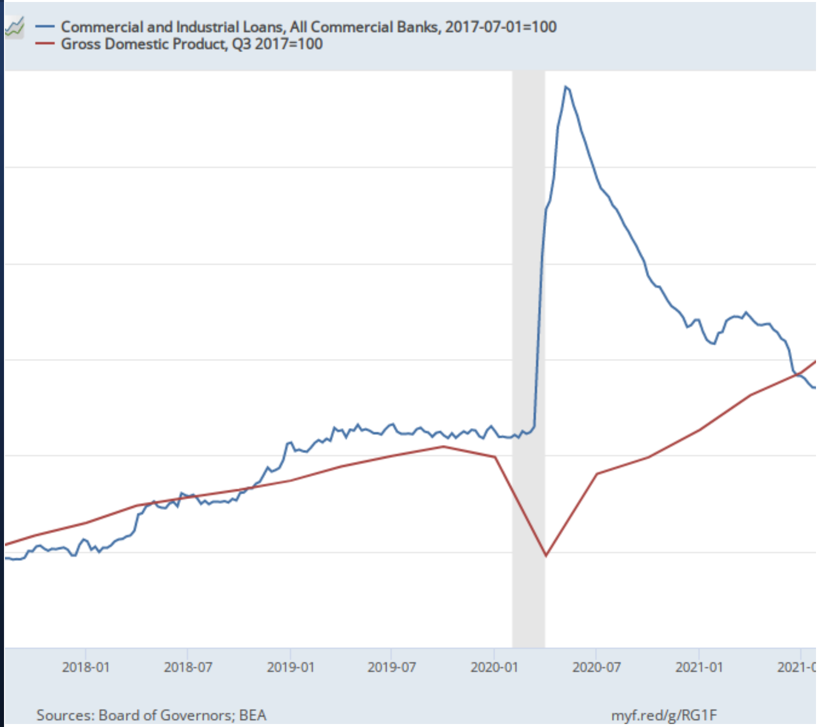


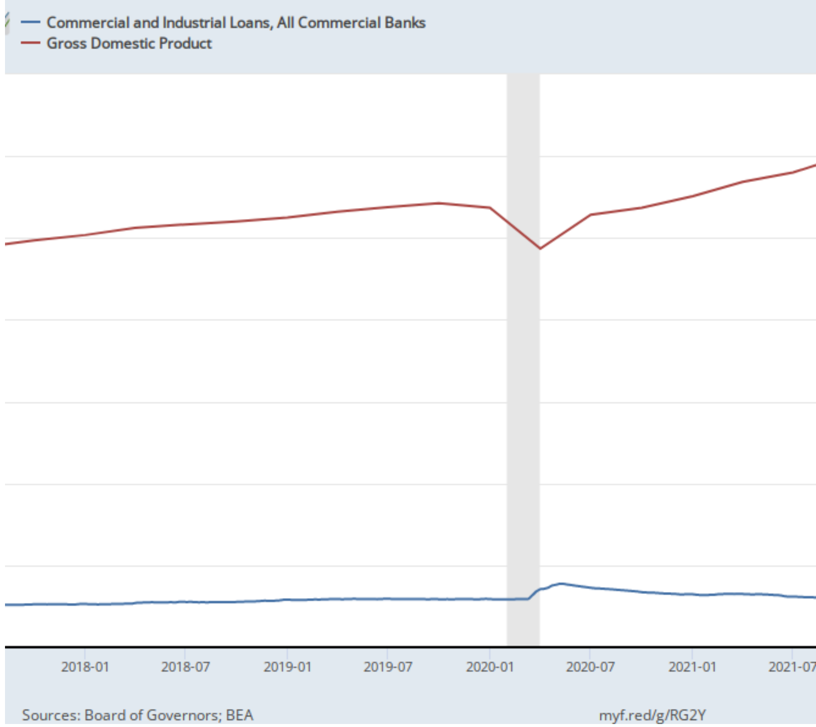
Within such complex aggregated data, there are many factors at work and many possible interpretations but to us, it seems fairly clear, that economic activity encountered an exogenous shock (the lockdown) that de-railed it and that the emergency borrowing facilities put in place by policymakers through the banking system injected sufficient cash to enable businesses and people to survive an otherwise existential threat and to be able to quickly resume activity and for companies to relatively normalise their operating and borrowing patterns.

So business as usual?

- Business is rarely if ever, as usual but something notable happened – economic activity then outstripped corporate borrowing. There are a number of factors that may help to explain this

1.Businesses had borrowed so much in the first half of 2020, that they deployed these funds throughout 2021 and 2022, so usual synchronisations are disrupted.
2. The US Government also injected unprecedented amounts into the economy during the 2020-21 fiscal years, which also boosted GDP.





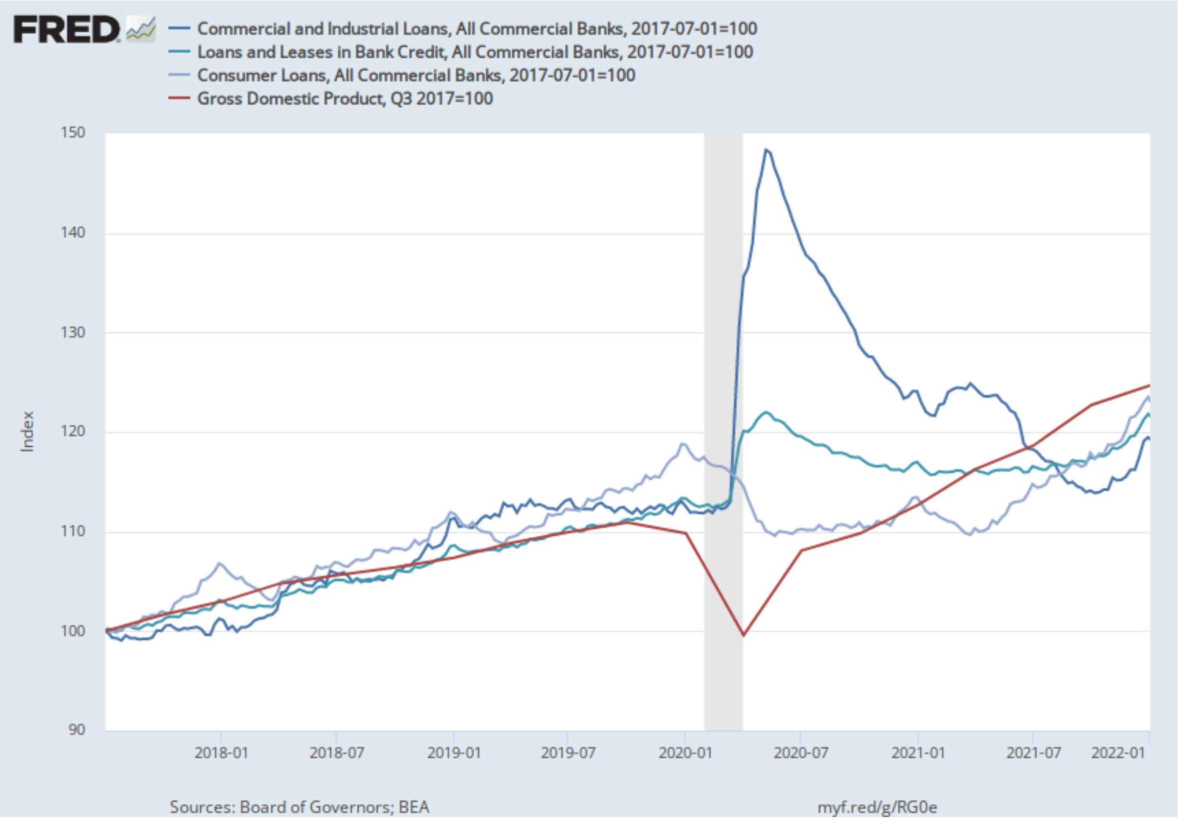
3. We have to be aware that GDP and business borrowing are of totally different magnitudes (the chart on the previous slide, shown on the left above plots the change in them, whereas the chart on the right above plots the actual USD value).

4. We also have to remember that the US economy is primarily driven by consumption – so to fully reflect that we also need to look at personal debt

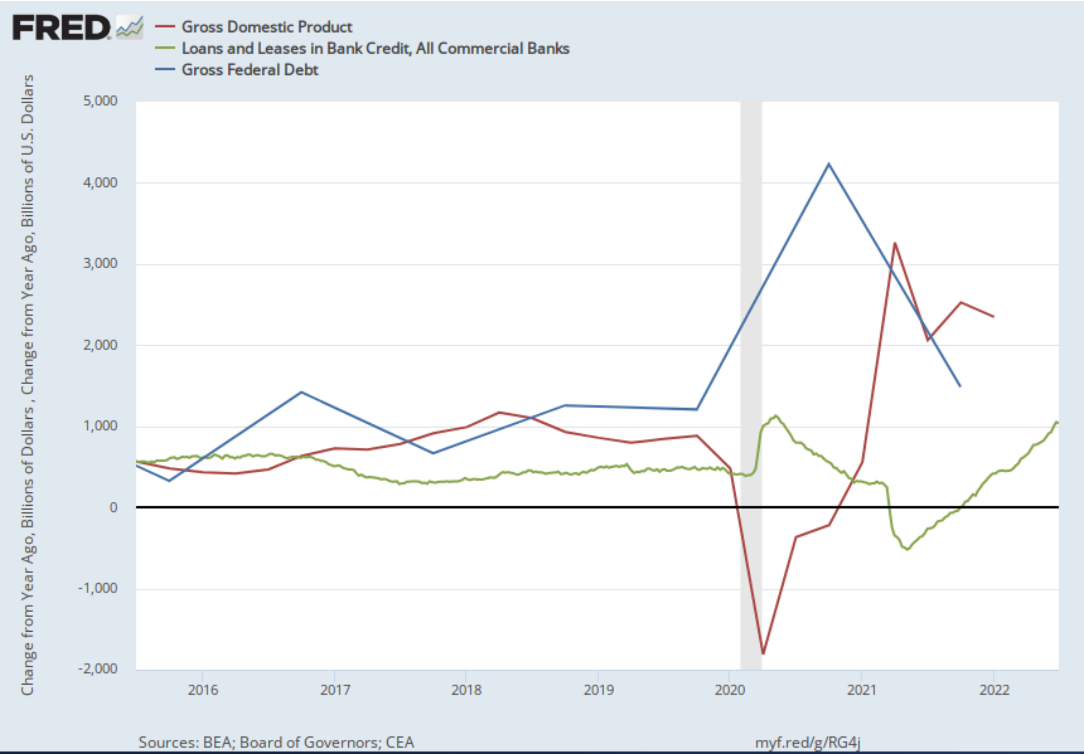
What happened with personal debt?

At the same time that corporate debt ballooned, private borrowing fell sharply – again this makes sense, people were less likely to borrow during lockdown and also they received government stimulus payments to help replace lost income. However, the fall in consumer lending was more than offset by the surge in business borrowing, so in aggregate loan amounts increased.

And of course, in addition to this, the government injected funds into the economy.



So it all adds up OK?



When we take a longer term look at the relationship between economic activity, we can see how government spending (the blue line) usually supplements borrowing to pay for increased economic activity and how in 2020, policymakers were faced with an external shock to the system of such a scale, that it required extreme government borrowing to fill the gap.

We can also see how last year, the US Government realised that they had to return to a more 'normal' trajectory.

So policymakers did good?

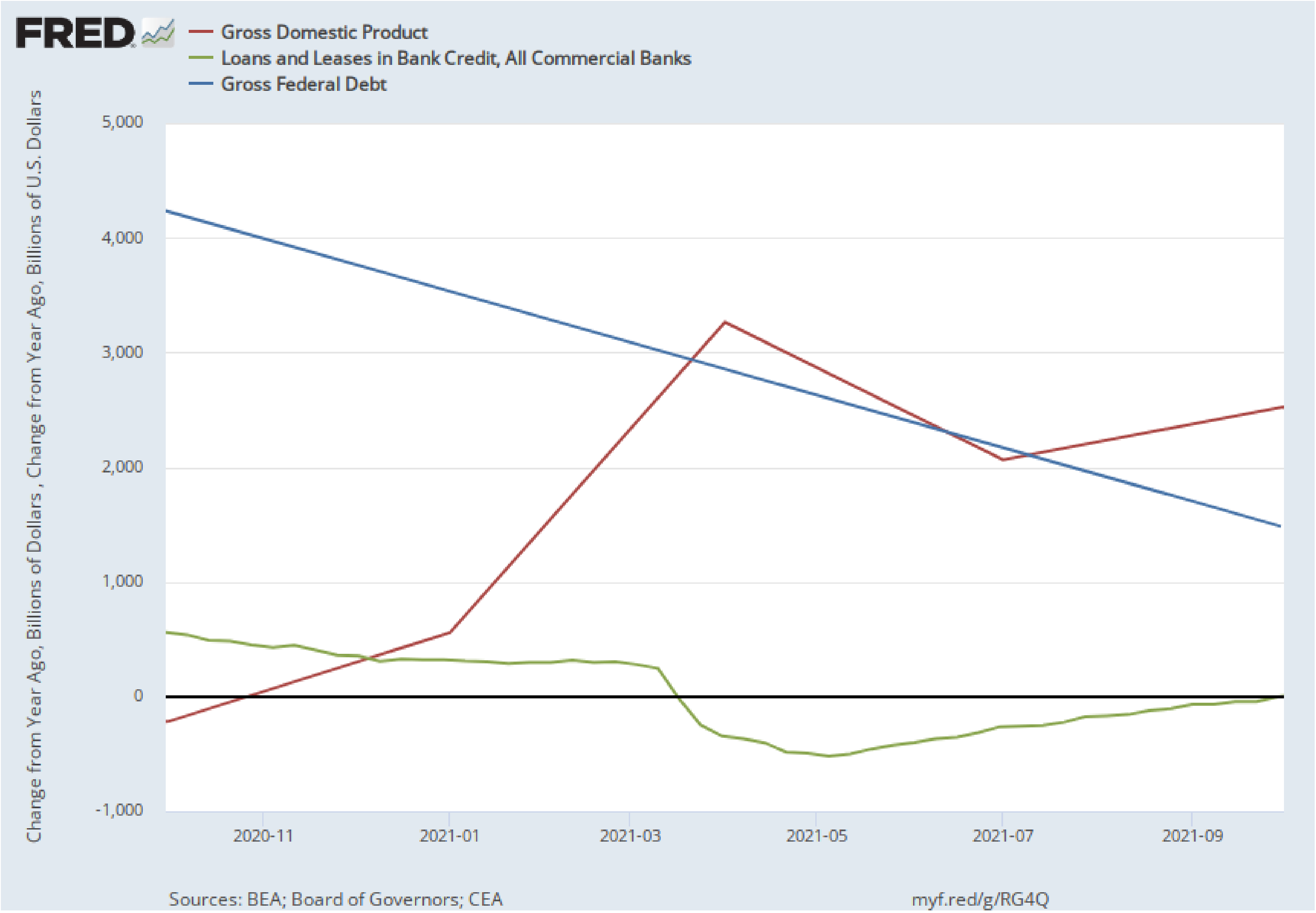
No.

They were doing well.

But they got carried away and overshot.

When fiscal year 2022 began (1st October 2021), it looked as though a mythical soft-landing (rarer than unicorn 💩 in the real world) was about to happen.

Government spending was falling sharply and GDP seemed to have stabilised, with the increase in borrowing widely posited as being able to take up the slack.



But that theory wasn't right?

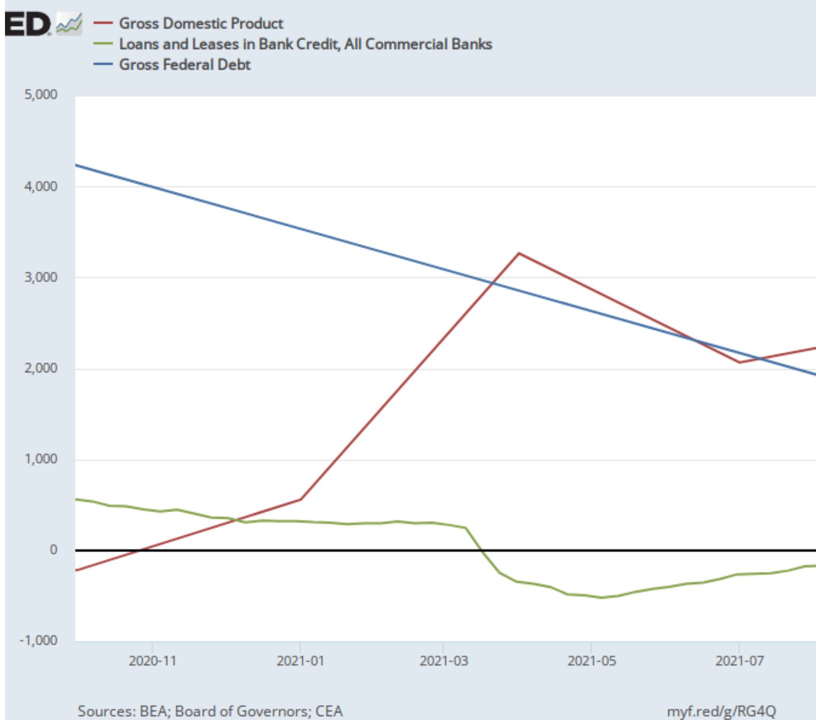
- No. To quote from Blackadder Goes Forth-

"You see, there was a tiny flaw in the plan, Baldrick."

"What was that, sir?"

"It was bollocks."

- The change in total borrowing from the trough to the start of the fiscal year had been around $500 billion.
- The gap that lending was being asked to fill was around $3 trillion on a gross basis and $1.8 trillion on a projected net basis.
- There was just no way, that it could be nearly big enough



The Maths

2021	
US Gov Funding Net	$2.8 Trillion
Private borrowing	$0.0 Trillion
Total credit input	$2.8 Trillion
Nominal GDP Growth	$2.1 Trillion
GDP Inflation	$1.2 Trillion
Real GDP Growth	$0.9 Trillion
Real Growth (excl gov)	-$1.9 Trillion

2022 (projected)	
US Gov Funding Net	$1.0 Trillion
Private borrowing	$0.8 Trillion
Nominal GDP Growth	$2.0 Trillion
GDP Inflation	$2.0 Trillion
Real GDP Growth	$0.0 Trillion
Real Growth (excl gov)	-$1.0 Trillion

In short, US GDP growth last year depended entirely on a combination of inflation and government funding. When we strip away inflation, we see that the US economy would have contracted by around -$1.9 trillion in the 2021 financial year, if it weren't for government spending.

In 2022, the government plans to cut spending by around $1.8 trillion, hoping that private borrowing (consumers & businesses) of around $0.8 trillion will be enough to fund growth. However, pretty much all of that borrowing will be 'swallowed up' by Inflation effects, unless nominal growth expands to offset that.

Therefore, while nominal GDP growth may be roughly in line with 2021, albeit with a falling trajectory as the year progresses, real growth looks set to stall due to Government having reined in spending programmes too sharply.

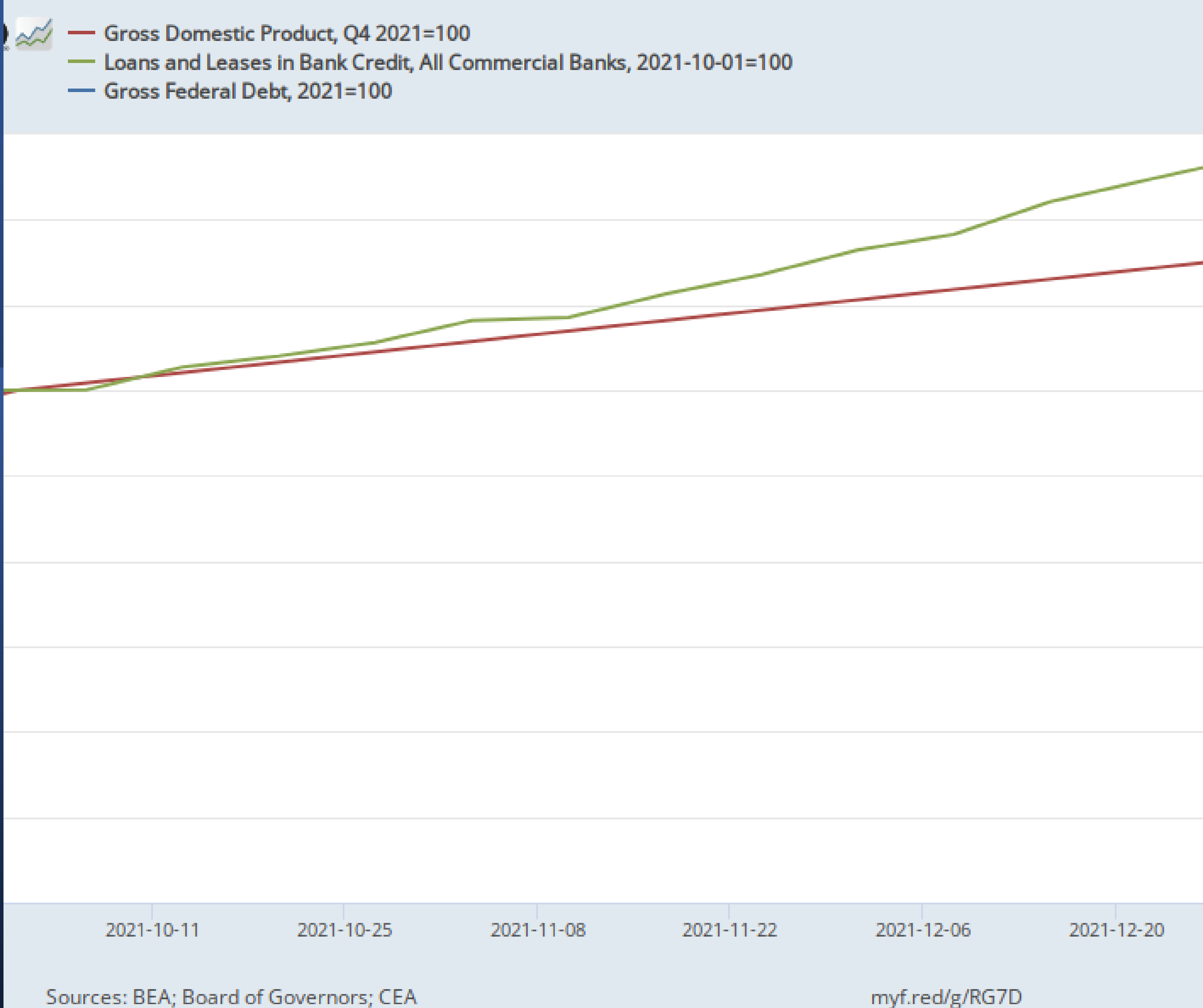
So, what happens now?

- Economies don’t have enough new money (in aggregate from governments and from borrowing) to generate growth, and therefore, they are slowing down – this was intended as growth was unsustainably ‘hot’ but the slowdown, exacerbated by policy fears of inflation, has been overrdone.
- This is creating a vicious spiral.
- In FY 2021, lending was flat as companies paid back or continued to deploy the huge 2020 lending spike and as consumer borrowing grew by 6.7% for the year and as the government injected net funding of $2.8 trillion into the economy, to generate GDP growth of 10.1% (or around $2.1 trillion). In other words, without the government funding the economy, 2021 would have resulted in a contraction or recession. Fortunately, that’s precisely what policymakers have the potential to achieve.
- However, their assumptions for 2022 were based on the US economy being able to function with $1.8 trillion less net funding.

How is that working out?

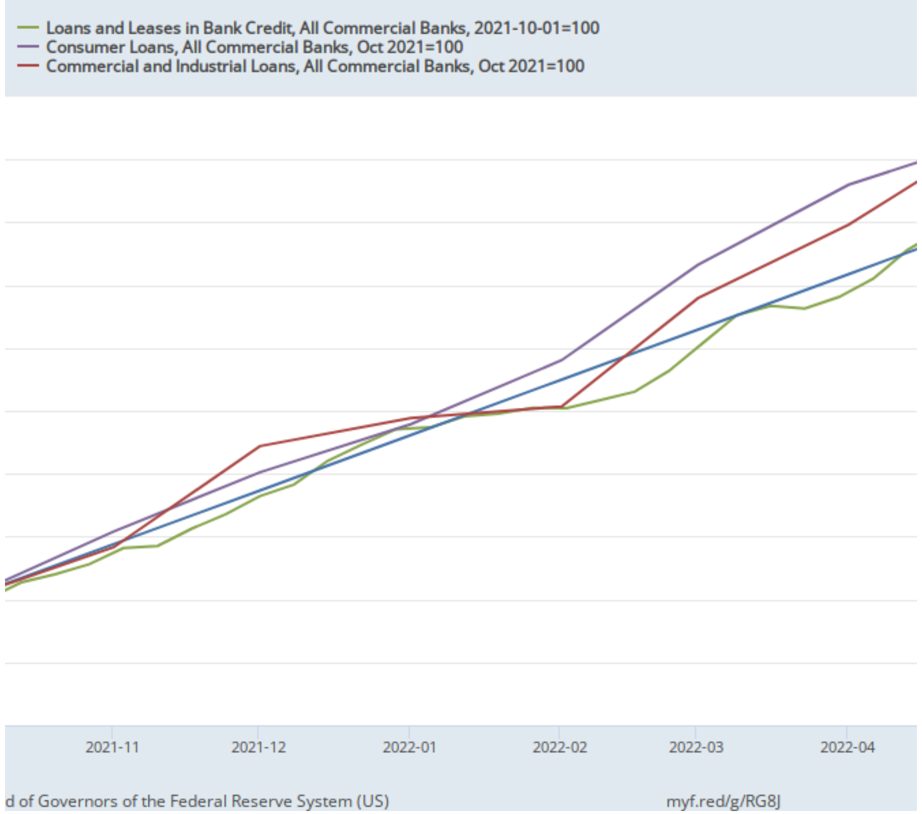
Economies don't have enough new money (in aggregate from governments and from borrowing) to generate growth, and therefore, they are slowing down. This was apparent during Q4 last year, as economic activity failed to keep pace with increased private debt. In fact, in inflation-adjusted terms, the US economy contracted in Q4 last year as well.

It has really come home to roost this year with economic contraction in the first quarter & fears of a weak second quarter and beyond.



Can we fix it?

- Yes, we can. But not without a major change in fiscal policy (i.e. government spending).
- Superficially, it might seem as though private borrowing can still save the day.
- As stated, in FY 2021, lending was flat, the government injected net funding of $2.8 trillion into the economy, which grew by 10.1% ($2.1 trillion).
- In the first 9 months of FY 2022, lending grew by over 10%, split fairly equally between businesses and consumers.



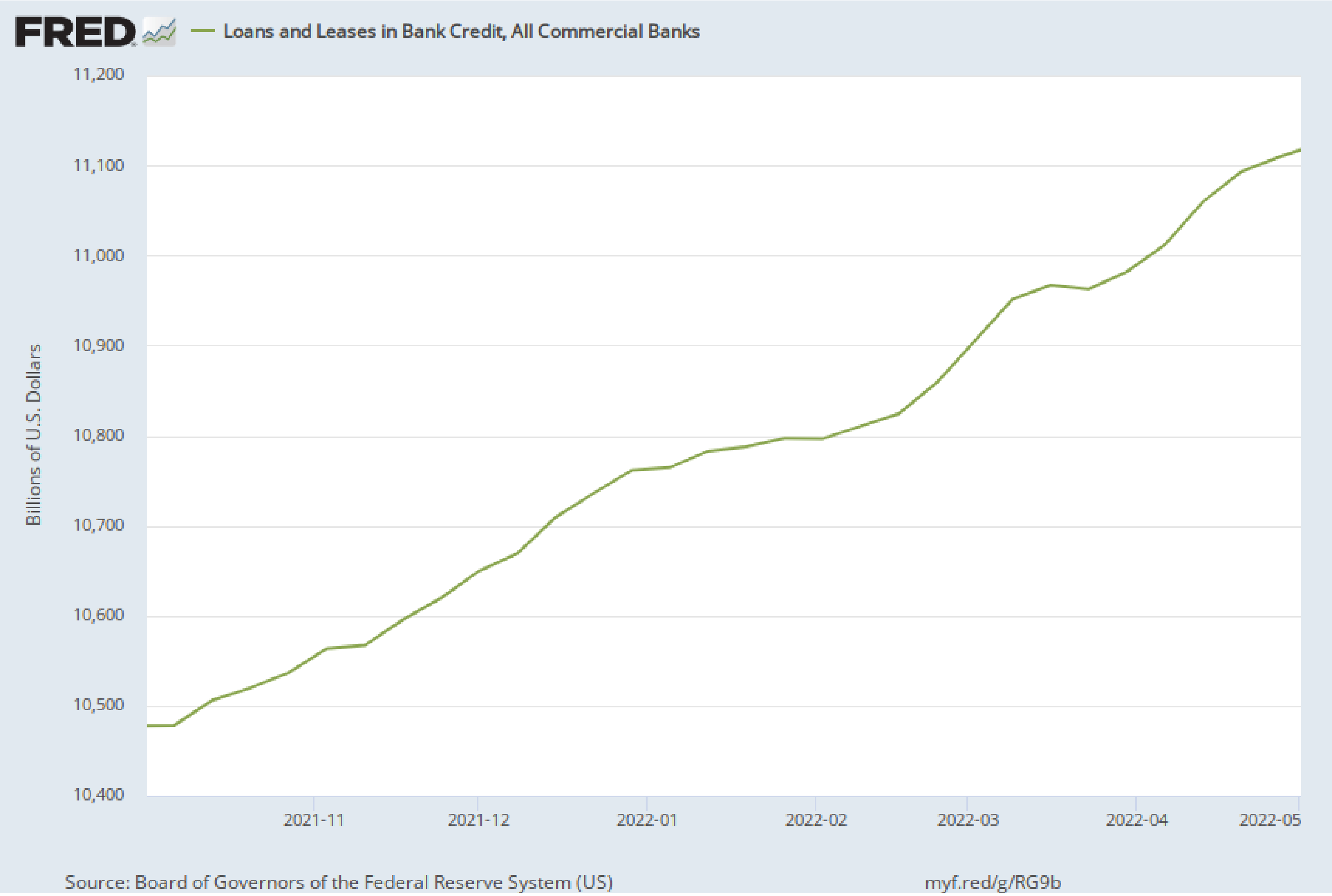
No, we can’t

However, the total increase in lending this fiscal year to date amounts to around $631 billion. Even if that pace is maintained, that amounts to an annual rate of ~ $840 billion.

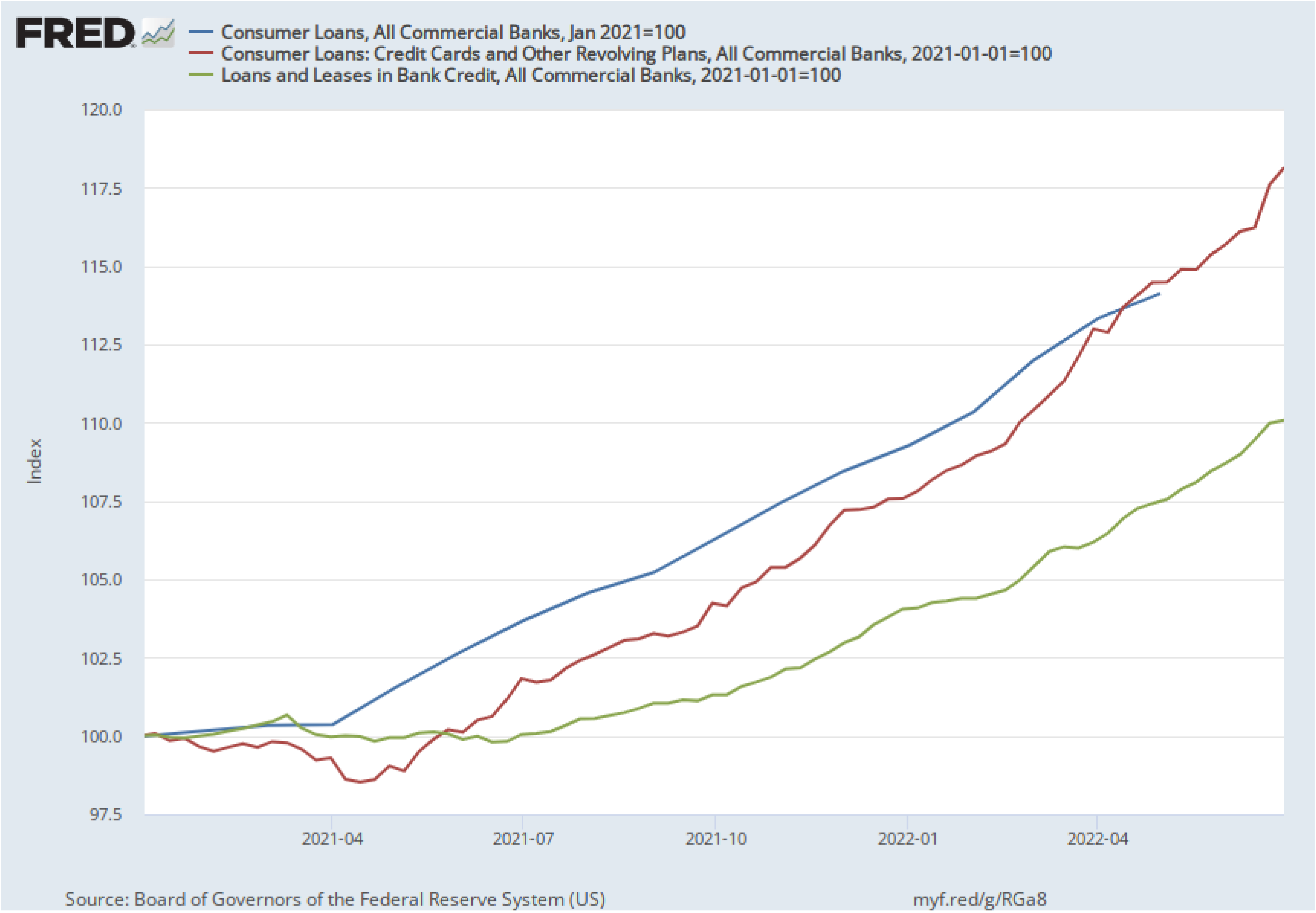
That $840 billion needs to help fill the shortfall left by the government taking away $1.8 trillion.

Ceteris paribus, that would mean a US economy growing not only by much less than last year (which is fine because last year was a blow out year) but also by much less than the rate of inflation.

When this happens, all things are not equal.



American Express No problem?



Big problem! The build-up in private debt is never the same as government spending because private debt has to be repaid whereas government debt doesn't (it's beyond me to explain why in this report, but Stephanie Kelton's book 'The Deficit Myth' does it better than I ever could anyway).

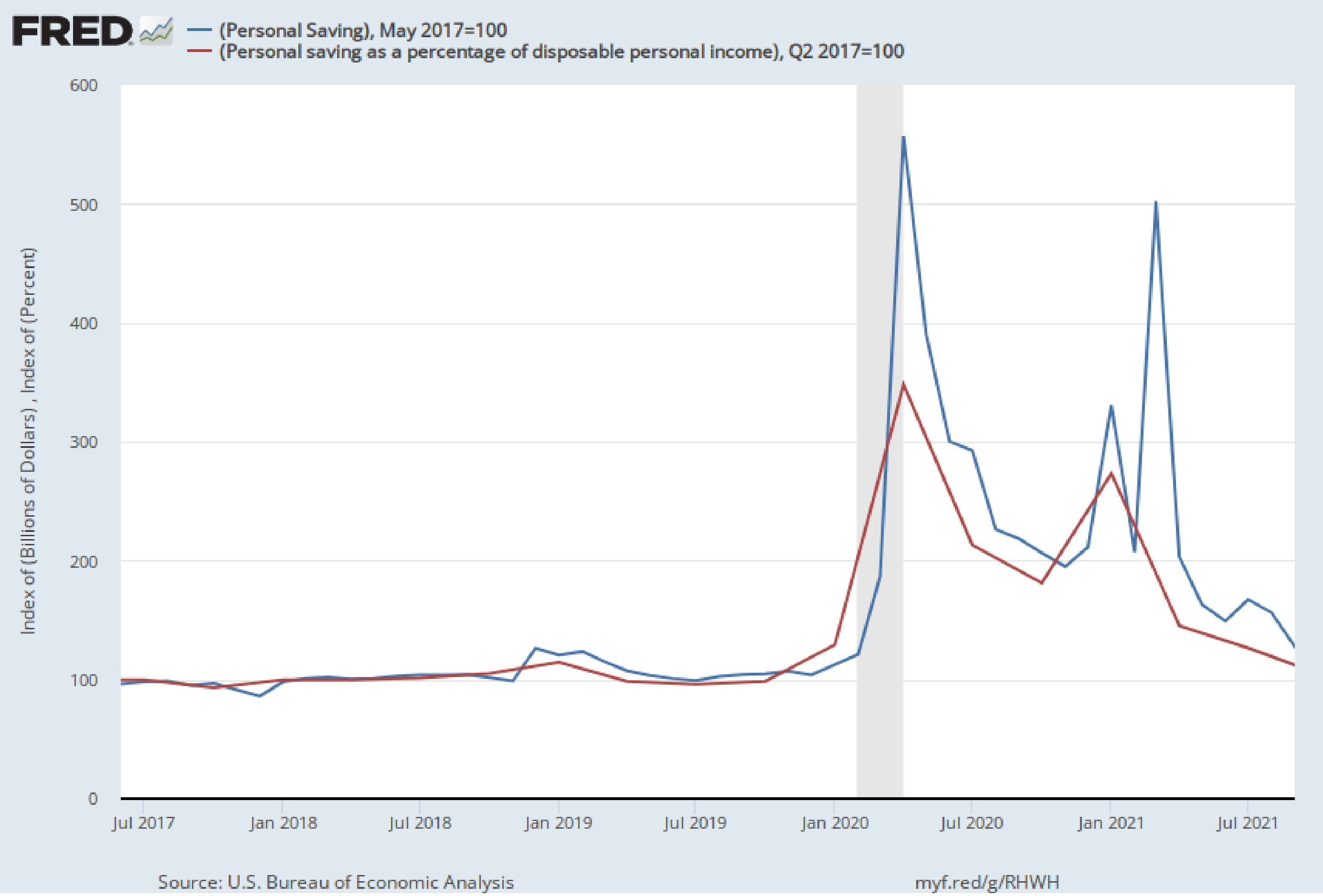
Even more alarming is the sharply deteriorating productive quality of private debt, where the main growth has been seen in personal credit card usage.

What happened to all the savings?

The deterioration of real personal savings balances is a typical signal of impending economic challenges – this was seen as a precursor to the recessions of 1990-91 and 2001 (it also occurred prior to the GFC but in a more volatile manner).

Personal savings had held up well during the years preceding the COVID-19 pandemic, a canary that continued to thrive.

It's well known that the stimulus policies adopted during 2020 boosted personal savings, both in Dollar terms and especially when adjusted as a proportion of (rapidly declining) personal income.



However, since then, personal savings have declined, not only back to pre-pandemic levels but lower and still falling.

Bankrate reports that the number of Americans comfortable with the level of their emergency savings has fallen from 56% in 2020 to 52% last year to 42% this year, and continuing to fall sharply.

We don't pretend to know what the tipping point would be, but it's clear that we should expect much lower consumption going forward.

Senile delinquents?

- The take-up in revolving credit and credit card spending and the evaporation of personal savings, combined with increased consumer price inflation, and less availability of credit in a slowing economy is reinforced by data about loan delinquencies (late payments) and charge offs (debts written off as unrecoverable).
- Charge offs usually lag delinquencies (lenders typically write off after at least 6 months of unrecovered non-payment).
- Delinquencies reached historic lows during the first part of last year and charge offs during the second half, since when, both have been rising. While they’re still at extremely low levels, the previous cycle low came in 2006 and we all know what followed in the next couple of years.
- There are warning signs for the US and western and global economies that the latest debt bomb could become extremely dangerous if policymakers fail to defuse it right now. Worryingly, there’s very little sign of that happening.

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