Steve Keen's Debtwatch Special Issue, March 18th 2008
Why Now?

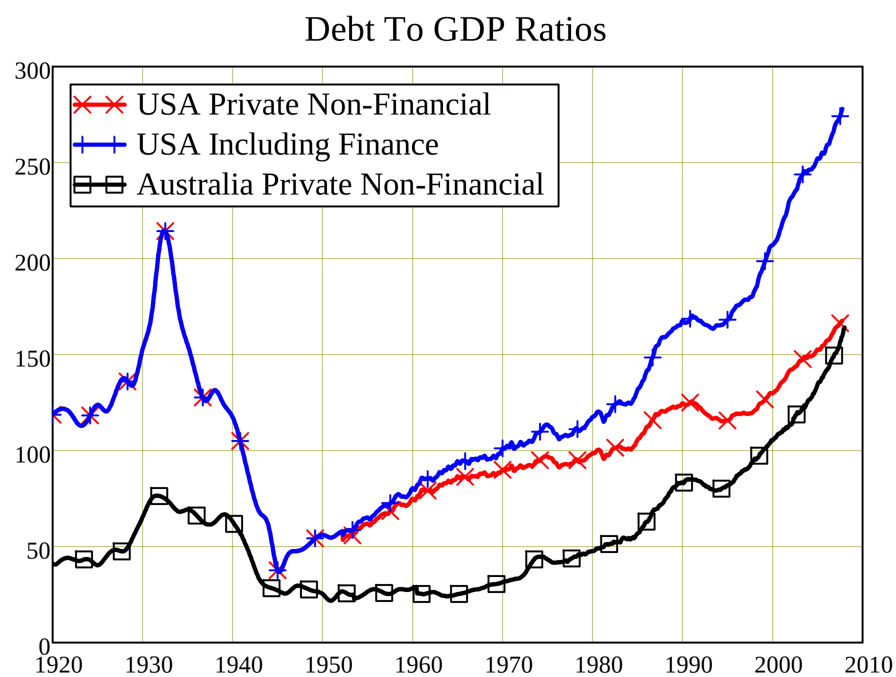
There has been no shortage of commentators and players willing to vouch that this is the worst financial crisis they have ever seen. Equally, there has been no shortage of bailout moves by the Federal Reserve--remedies that put "the Greenspan Put" to shame in their magnitude.

And yet the market meltdown continues, and the casualties continue to mount, with Bear Stearns the latest--and surely not the last.

In all this, no one yet seems to have posed the question of "why now?". Why is the crisis clearly more severe this time than ever before, and why are remedies that worked relatively quickly in the past (remember the fast turnaround of the market after October 1987, and the rapid recovery from the rescue of Long Term Capital Management?) failling today?

The answer is, simply, that the world has never in its history carried the level of debt that it is carrying today. The remedies that worked when America's private debt to GDP ratio was a mere 150 percent (see Figure 1) are inadequate when that ratio is 275 percent.

Figure 1: Debt to GDP Ratios over the Long Term



Those remedies worked in the past, not because they "solved the problem", but because they encouraged the renewal of the debt accumulation process. Each Federal Reserve rescue was followed by a renewed growth of debt relative to income--without which, the economy would have gone into a slump, rather than a boom.

The traditional cure to a financial crisis--to restart the debt accumulation engine--can't work this time, because in America today, there's no-one left to lend to (there is no sub-subprime borrower), and no lender willing to risk its capital in yet more debt.

So the dominoes will continue to fall. Manoeuvres like extending the range of securities that are eligible for the Federal Reserve's repo window will provide temporary liquidity. But while that liquidity exists, the financiers then have to find someone else willing to give them the medium term credit needed to honour the other side of the repo agreement--to buy the securities back from the Fed when the repo agreement expires.

That could be when the next dose of the proverbial manure hits the proverbial fan. The repo agreements that the Fed will arrange will doubtless involve discounts to face value of the bonds being accepted as securities. The firms that take out that temporary liquidity then have to buy those bonds back--and without reserves to draw upon, that will involve further debt.

What odds that it won't be possible to find that debt, unless the bonds can be repossessed at a higher still discount? What will the Fed do then? Bankrupt the primary dealers who can't honour the second leg of their repo agreements? Validate the folly of sub-primes by permanently buying the toxic securities they have accepted as collateral--and at what discount? And, with what money, since the reserves of the Federal Reserve are dwarfed by the scale of outstanding private debt?

So the real fun on the markets will begin in three months time, when the credit extended by the expansion of the liquidity window yesterday by the Federal Reserve has to be repaid.

"Fight Inflation First? *Not on your Nellie*...

One more recent piece of news out of the USA deserves comment: the fact that inflation for the month of February was zero. This might be a flash in the pan: certainly there are plenty of sources of inflation in the world economy now, amplified in the USA by its depreciating currency.

From one point of view, it is good news, because it means the Fed doesn't have to excuse itself from kowtowing to the market's standard paranoia about inflation.

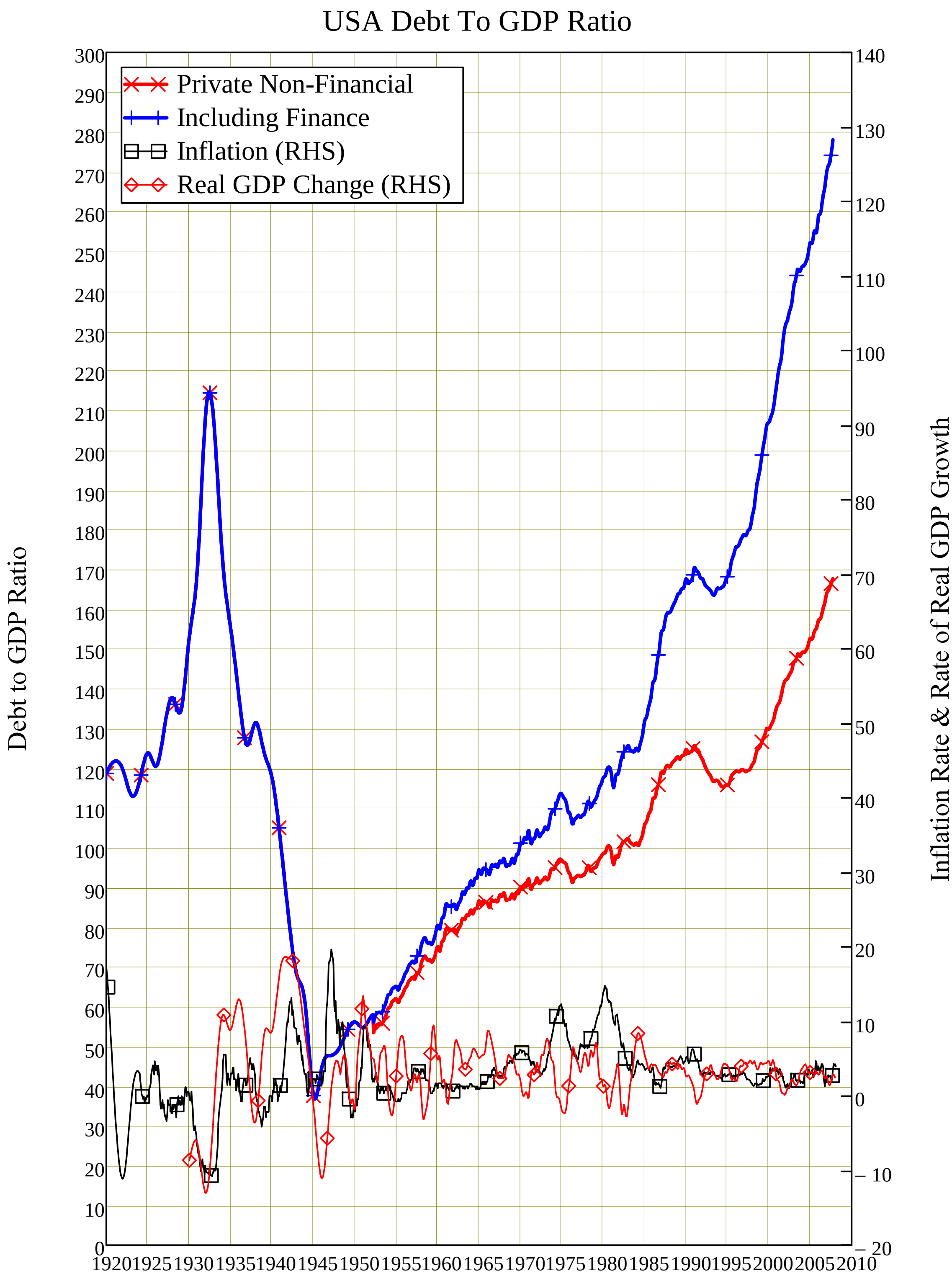
But in another sense, it could be a harbinger of *deflation*--and this is the last thing the USA--or the world in general--needs. That is emphasised by taking another look at the USA debt data in Figure 1--this time in conjunction with data on inflation and real GDP change--in Figure 2 below.

Notice that the USA's debt to GDP ratio peaked at 215% in 1932--three years after the Great Depression began--having been "just" 150 percent when the Great Crash occurred.

The reason that the ratio continued to grow after the Depression struck is twofold: firstly, real output fell--and by as much as 13% in 1932; but secondly, because prices fell by over 10% p.a. in 1930-32. That falling price level increased the debt burden, even as Americans tried to pay their debt down.

For the record, the USA revisited the peak for the non-financial debt to GDP ratio in 2005--and the ratio including the financial sector debt exploded past even the Great Depression's peak in 2000. It is now 278 percent, versus 150 percent in 1929, and 215 percent in 1932.

Figure 2: Debt and Deflation



T1 =

	0	1	2	3
0	"Date"	"USA Private Debt"	"Inc. Financial"	"Aus. Private Debt"
1	2008	168	278	160
2	2005	151	249	131
3	2002	141	228	113
4	1999	125	193	99
5	1996	119	174	85
6	1993	119	165	81
7	1990	123	165	83
8	1987	116	150	69
9	1984	101	124	54
10	1981	100	120	49
11	1978	93	109	44
12	1975	97	113	44
13	1972	91	103	33
14	1969	87	96	30
15	1966	86	94	26
16	1963	80	87	26
17	1960	73	79	28
18	1957	67	71	26
19	1954	58	61	23
20	1951	55	55	22
21	1948	48	48	29
22	1945	42	42	28
23	1942	87	87	48
24	1939	127	127	66
25	1936	142	142	67
26	1933	212	212	74
27	1930	148	148	63
28	1927	127	127	48
29	1924	115	115	44
30	1921	121	121	42
31				

T2 =

	0	1	2
0	"Date"	"USA Inflation"	"USA Real GDP Growth"
1	2008	4.3	2.5
2	2005	3	3.1
3	2002	1.1	0.2
4	1999	1.7	4.5
5	1996	2.7	2
6	1993	3.3	4.1
7	1990	5.2	2.7
8	1987	1.5	2.8
9	1984	4.2	7.7
10	1981	11.8	-0
11	1978	6.8	5
12	1975	11.8	-1.9
13	1972	3.3	4.5
14	1969	4.4	4.9
15	1966	1.9	8.5
16	1963	1.3	4.1
17	1960	1	4.9
18	1957	3	1.8
19	1954	1.1	0.4
20	1951	8.1	13.4
21	1948	10.2	4.4
22	1945	2.3	-1.1
23	1942	11.3	18.5
24	1939	-1.4	8.1
25	1936	1.5	13
26	1933	-9.8	-1.3
27	1930	0	-8.6
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