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The dangers of being right for the wrong reasons: Part 1

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There are so many factors that could affect the global economy in 2016, analysts could actually be right for the wrong reasons – and that could be disastrous.

> *And although there are a lot of Americans who understandably think that government money would be better spent going directly to families and businesses instead of banks – "where's our bailout?," they ask – the truth is that a dollar of capital in a bank can actually result in eight or ten dollars of loans to families and businesses, a multiplier effect that can ultimately lead to a faster pace of economic growth.*
>
> *- US President Barak Obama, April 2009*[1]

In my recent article *A time for analysis not panic*,[2] I mentioned that, for once, I wouldn't be making any forecasts for 2016 because the next eleven months or so are just too unpredictable.

It seems that I am going against the grain of either a large consensus or just a very loud one. First it was the Royal Bank of Scotland, which warned investors of a 'cataclysmic year'[3], then it was Société Générale strategist Albert Edwards. The man renowned as the City of London's most vocal *bear* suggested that we were heading for a global crisis as severe as 2008/2009.[4]

Albert may well be right but, even to me (the supposed 'Bear of Bangkok'), the RBS tone runs the risk of sounding a little too hysterical. Like myself, Albert has consistently explained the dangers of experimental policies in a debt-deflation environment for several years. Since the redoubtable Bob Janjuah's departure, RBS don't seem to have been quite so clear in their message. The sudden appearance of a Cassandra on every street corner (in the Square Mile at least) coming somewhat out of the blue and without context seems all too much like doomsday prepping; especially if it still begs the question as to why this narrative has suddenly come to a head. Is it because there's a genuine feeling that 2016 will be

[1] http://www.ft.com/intl/cms/s/0/c2133db0-2901-11de-bc5e-00144feabdc0.html
[2] http://www.mbmg-investment.com/in-the-media/inthemedia/75
[3] http://www.straitstimes.com/business/companies-markets/sell-everything-2016-will-be-a-cataclysmic-year-rbs-warns-investors
[4] http://www.theguardian.com/business/2016/jan/12/beware-great-2016-financial-crisis-warns-city-pessimist

the year financial crisis returns? Or is it merely because analysts looked at all the red lines and down arrows on the weekly charts when they were prompted for their New Year's predictions?

Either way, there is some sound reasoning as to why financial crisis is coming. I'm just not convinced it will happen this year or that it needs to be such a uniformly destructive event from every individual viewpoint as some seem to suggest.

That said, there are some very, very significant issues to address.

Eurozone

The Eurozone is a major flashpoint. The European Central Bank has embarked on a three-pronged attack of quantitative easing (QE),[5] a negative interest rate policy (NIRP)[6] and public sector austerity. Let's call it the *ECBQENIRPPSA* – or, more accurately, *a recipe for disaster*. Quite why the ECB feels the way forward is to replicate Japan's economic model from 1990 onwards is beyond me. The Land of the Rising Sun has been caught in a debt-deflation cycle ever since.[7] However, the ECB appears to think the Eurozone is some kind of economic exception and will avoid this fate. It isn't and it won't. Debt deflation is structural. It's the point in the cycle when debt (which is the biggest single driver of both economic activity and asset prices) reaches a point reminiscent of Monty Python's Mr. Creosote[8] and just can't expand any further without exploding.

With debt-deflation, company profits are squeezed, thus salaries remain low and the disposable income to pay off debt remains limited. Stagnation can pervade for a very, very long period of time. Hence Japan's debt-to-GDP ratio has hardly reduced, despite the economic suffering there in the last 10-15 years.[9]

Private debt

Whilst the IMF, Eurostat and other providers of economic indicators continue to obsessively publish figures on government debt, private debt remains the critical factor. True, there has been significant deleverage since 2009 when private debt rates were at around 98% of GDP. Yet, Q3 2015 data shows

[5] http://www.wsj.com/articles/mario-draghi-says-eurozone-inflation-is-weaker-than-expected-1454345393

[6] http://www.zerohedge.com/news/2014-06-05/nirp-has-arrived-europe-officially-enters-monetary-twilight-zone

[7] http://www.ideaeconomics.org/blog/2015/1/13/steve-keens-2015-outlook

[8] https://en.wikipedia.org/wiki/Mr_Creosote

[9] World Bank Data

the ratio at around 79.5%[10] - still a considerable amount and far too high a base on which to build a sustainable rally. Governments have misguidedly try to fill this gap, which has papered over the cracks rather than fix the foundations. And as the cracks become ever wider, governments globally are taking increasingly desperate measures to apply more wall paper. The BoJ's decision to herald negative interest rates[11] was just the continuation of this attempt to cover up the deeper problems and shouldn't have come as a shock to anyone. Governments globally will adopt ever more radical measures which are ultimately doomed to fail in a way that will seem quite catastrophic but will give some semblance of restoring stability before that happens.

And that, in essence, is why 2016 is impossible to predict. As my IDEA Economics colleague Prof. Steve Keen recently put it, "The scary stuff isn't there on the same scale. It's the depressing stuff that is. That's the situation Japan's been in, with having built up too much private debt, too much bank debt."[12]

So the cracks will get ever wider but governments seem determined to keep doing everything that they can to hide them from view. Until they reach the point that they can't do this anymore. Some commentators suggest that this will happen when the *Central Banks have run out of tools*.[13] But that's not quite right in my view. I'd say that a wallpaper brush and some paste aren't the right tools in the first place to deal with shaky foundations. As Steve Keen says, Central Banks will continue until they have "exhausted the capacity to use the wrong tools but the right ones are still sitting there and they're ignoring them."[14]

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Disclaimers:

[10] World Bank Data

[11] http://www.cnbc.com/2016/01/28/bank-of-japan-adopts-negative-interest-rate-policy-reuters.html

[12] https://www.youtube.com/watch?v=7OSHu80IXi0&feature=youtu.be&t=3m45s

[13] http://www.ft.com/intl/cms/s/0/193da290-4ef5-11e5-8642-453585f2cfcd.html

[14] https://www.youtube.com/watch?v=7OSHu80IXi0&feature=youtu.be&t=3m45s

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