



Riding the Debt Deflation Guardrails

The Levy Economics Institute

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MacroStrategy Edge

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Prevailing Macro View

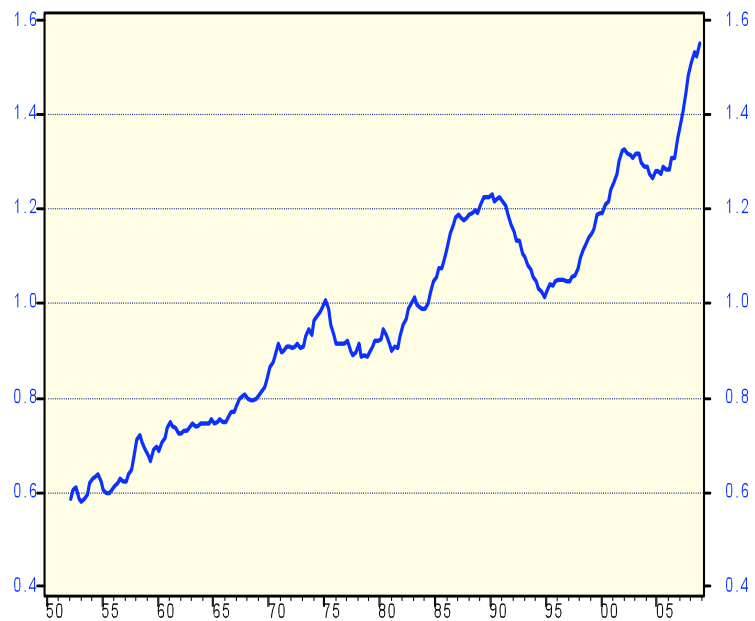
- Price adjustments will lead to FE market equilibrium
- Deregulation or self regulation is to be favored
- Monetary policy can correct most coordination failures
- Fiscal policy will tend to be neutralized by crowding out, twin deficits, or tax anticipation effects
- Financial markets adequately signal the correct size and distribution of tangible capital investment
- Asset bubbles cannot be identified in advance
- But monetary policy can contain post bubble disruptions, including deflation episodes, even with a zero policy rate

Irving Fisher's 1933 Checklist

- (1) Debt liquidation leads to distress selling and to
- (2) A fall in the level of prices
- (3) A fall in the level of prices
- (4) A still greater fall in the net worths of business, precipitating bankruptcies and
- (5) A like fall in profits, which in a "capitalistic," that is, a private-profit society, leads the concerns which are running at a loss to make
- (6) A reduction in output, in trade and in employment of labor
- (7) Pessimism and loss of confidence, which in turn lead to
- (8) Hoarding and slowing down still more the velocity of circulation.

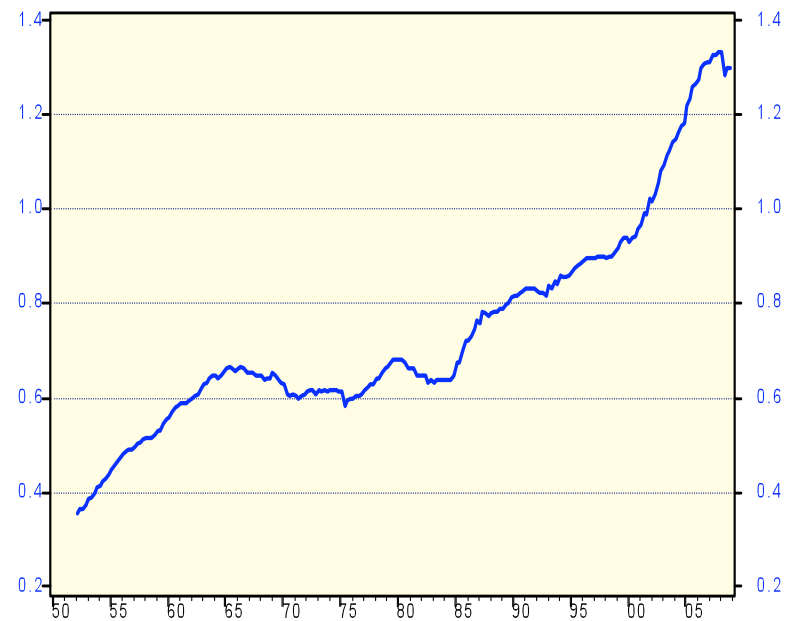
Private Debt to Income Ratios

Nonfinancial Business Debt to Gross Value Added



Source: Haver Analytics

Household Debt
to Disposable Income Ratio

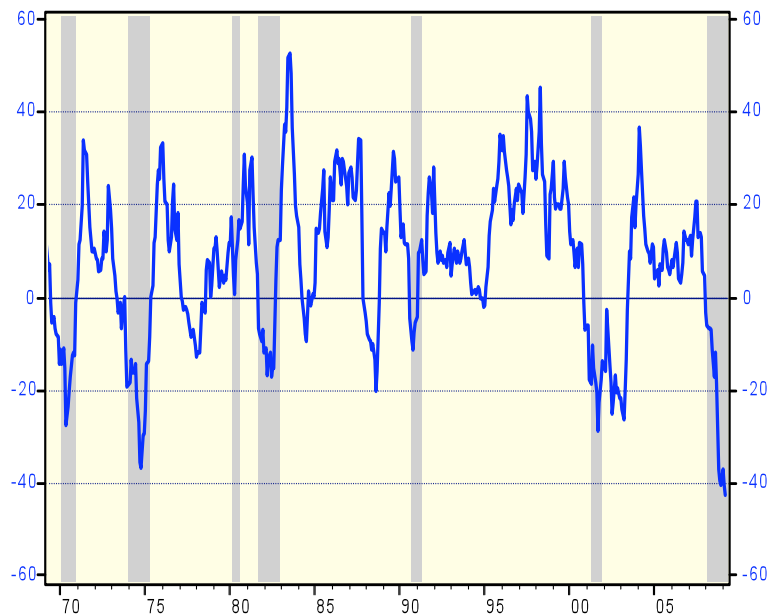


Source: Haver Analytics

Asset Price Deflation

Stock Price Index: Standard & Poor's 500 Composite

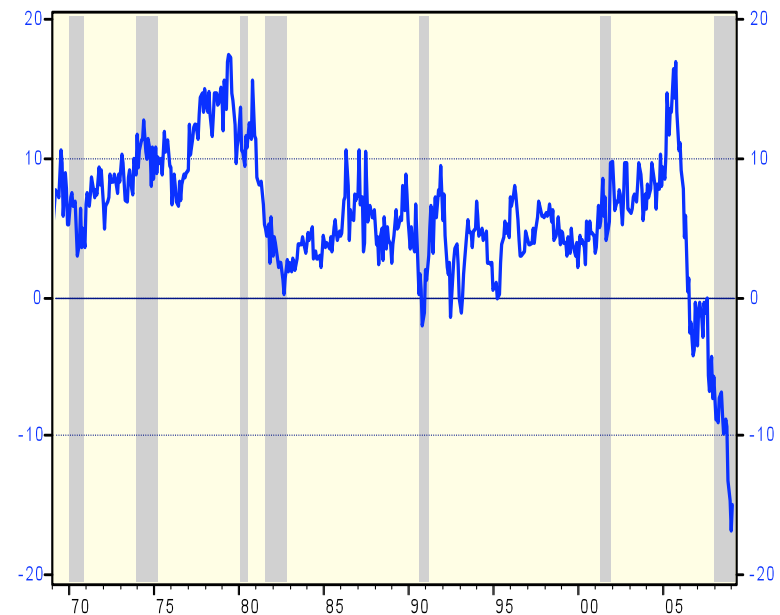
% Change - Year to Year 1941-43=10



Source: Wall Street Journal /Haver Analytics

Median Existing Home Price

% Change - Year to Year



Source: National Association of Realtors /Haver Analytics

Product Price Deflation

Nonfinancial Corporate Price Deflator

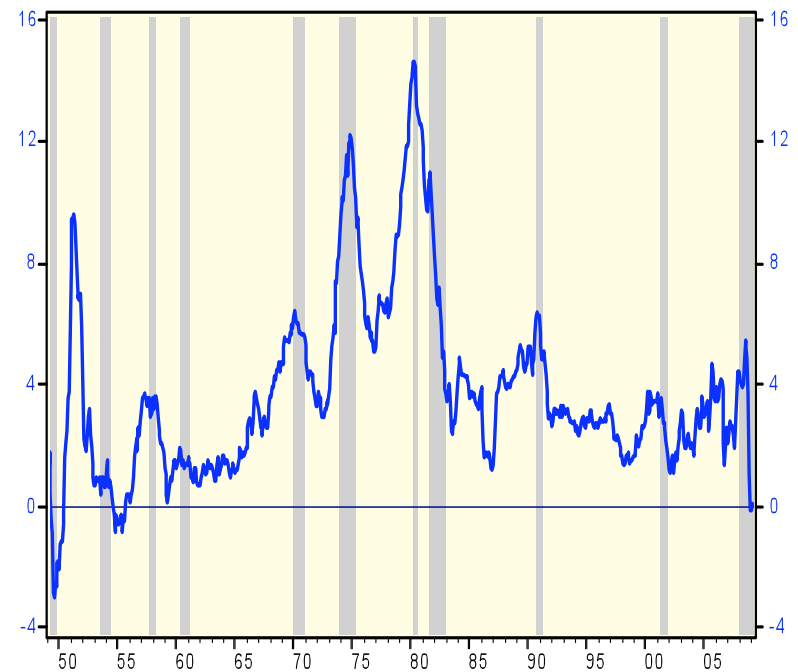
% Change - Year to Year



Source: Bureau of Labor Statistics /Haver Analytics

CPI-U: All Items

% Change - Year to Year SA, 1982-84=100

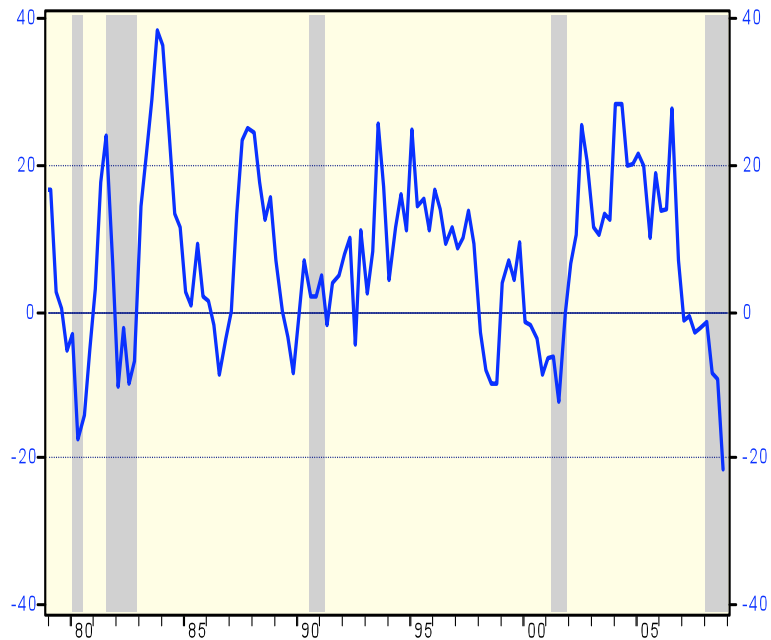


Source: Bureau of Labor Statistics /Haver Analytics

Private Income Deflation

Corporate Profits with IVA and CCAAdj

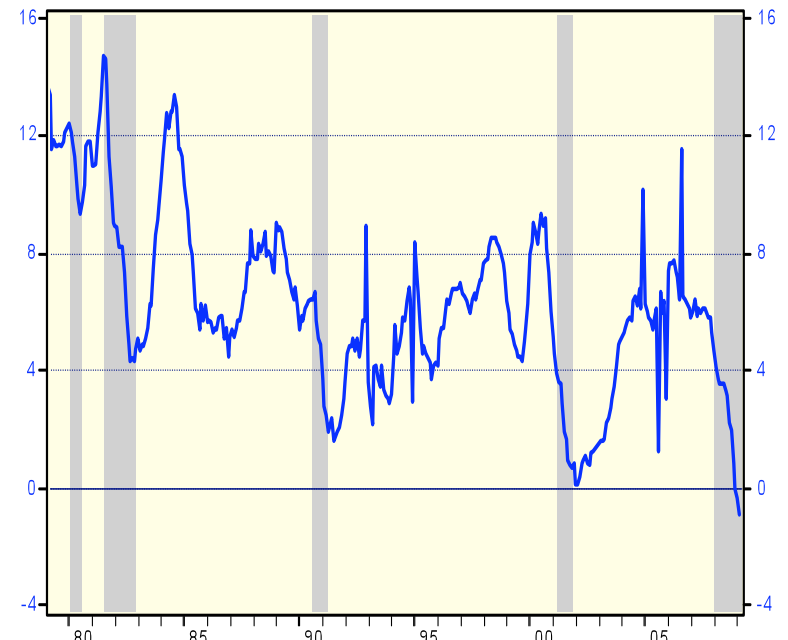
% Change - Year to Year SAAR, Bil.\$



Source: Bureau of Economic Analysis /Haver Analytics

Personal Income ex Transfers

% Change - Year to Year

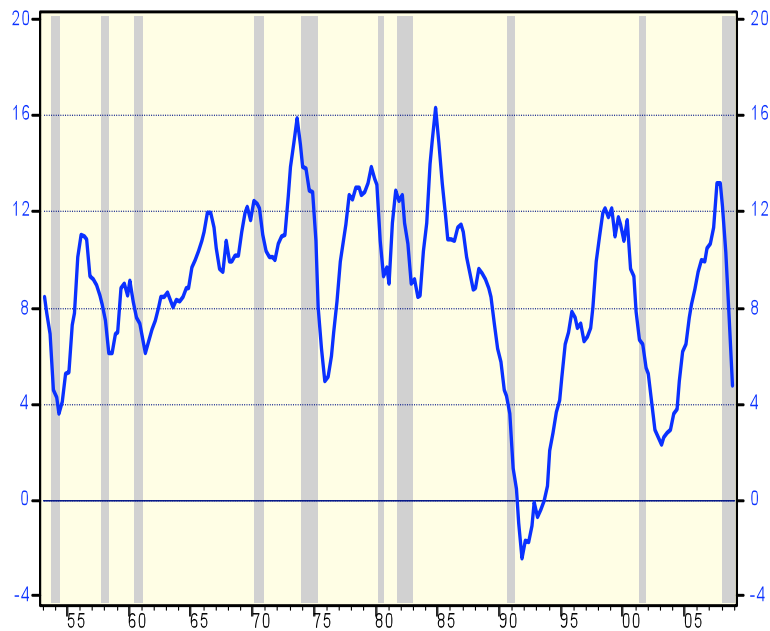


Source: Haver Analytics

Private Debt Reduction

Nonfinancial Business Debt Outstanding

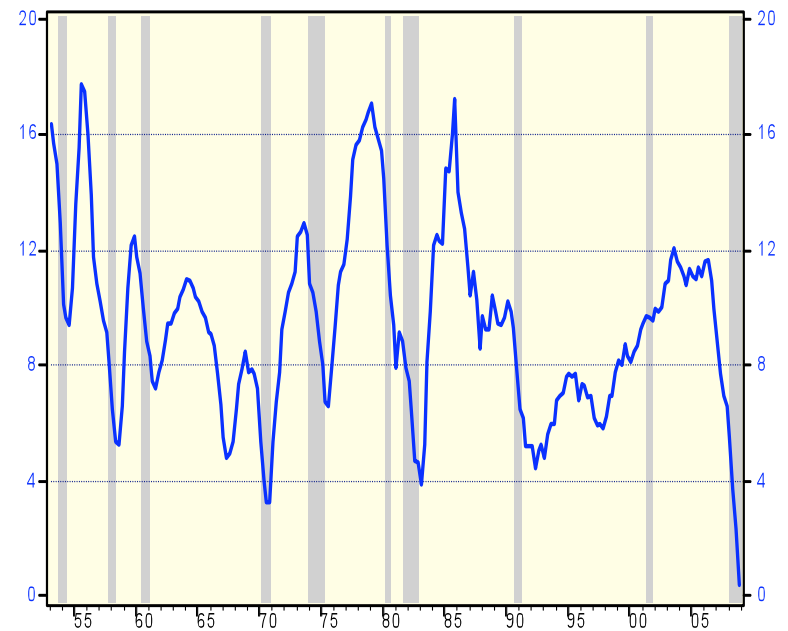
% Change - Year to Year



Source: Federal Reserve Board /Haver Analytics

Households Debt Outstanding

% Change - Year to Year



Source: Federal Reserve Board /Haver Analytics

Alternative Macro View

- Price adjustments can amplify market disequilibrium
- This is especially likely for durable assets owned with leverage (as well as for financial claims on same)
- Active fiscal and monetary policy are likely to be required to achieve a full employment growth path
- Financial markets can signal major misallocations of tangible capital investment
- Asset bubbles and financial imbalances can be identified before they erupt into a financial crisis
- Evolving regulation can help set adequate margins of safety and corridors of stability in financial markets
- Inflation stability is not a sufficient condition for financial stability, nor is it always the highest CB priority

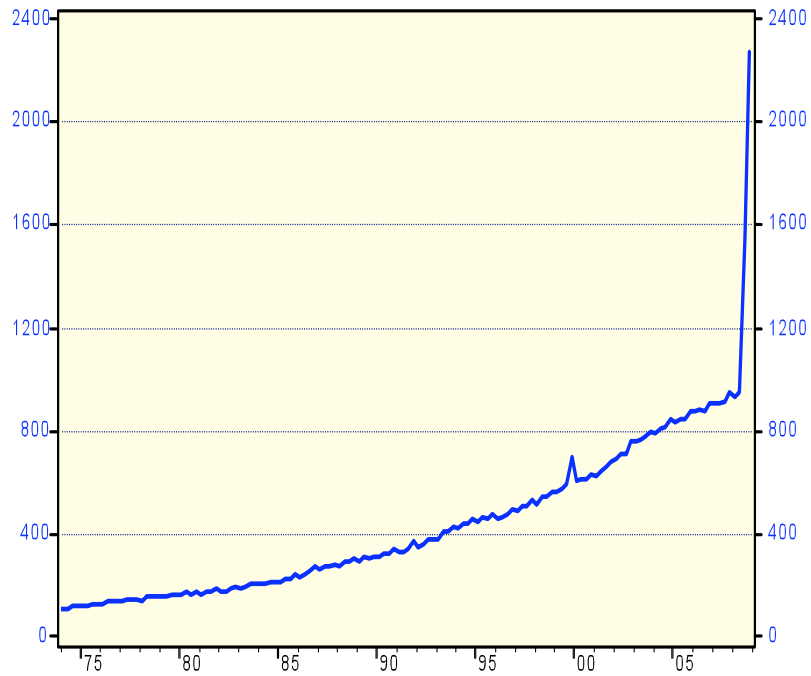
Minsky: Why “It” Can’t Happen Again

- Monetary stimulus and lender of last resort operations directed at stabilizing asset prices
- Fiscal stimulus directed at stabilizing private incomes
- Where necessary, government manages orderly wind downs of failing institutions that could trigger systemic risk

Bending Minsky's Guardrails

Monetary Authority: Financial Assets

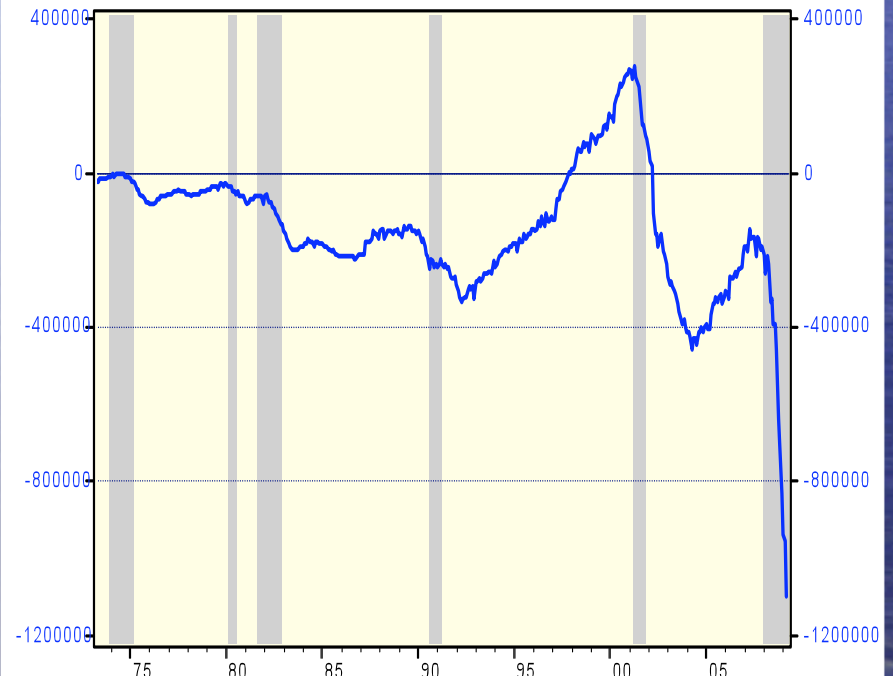
NSA, Bil. \$



Source: Federal Reserve Board /Haver Analytics

Federal Surplus {+} or Deficit {-}

12-month Moving Total Mil. \$

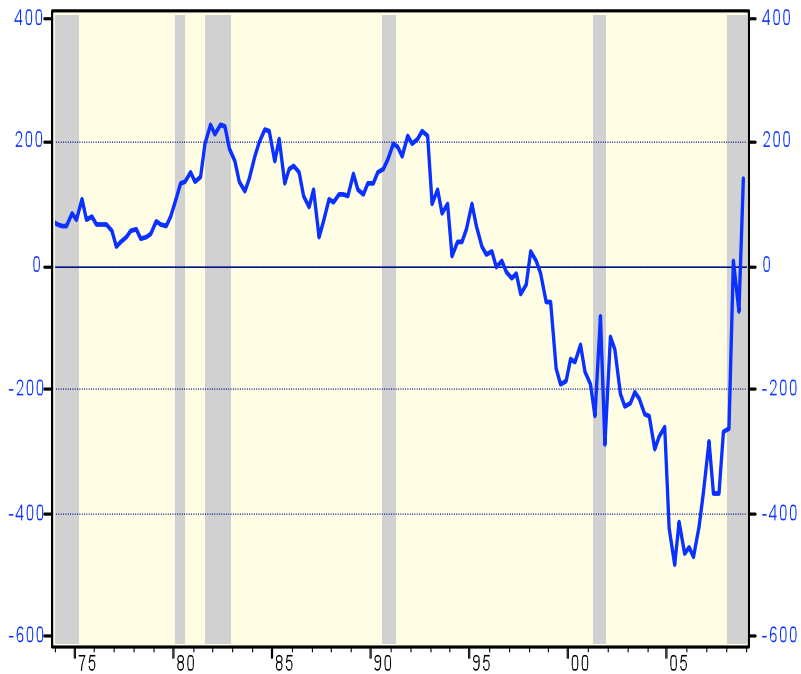


Source: U.S. Treasury /Haver Analytics

Bending Minsky's Guardrails

US Household Financial Balance

(billions)



Source: Haver Analytics

US Current Account Balance

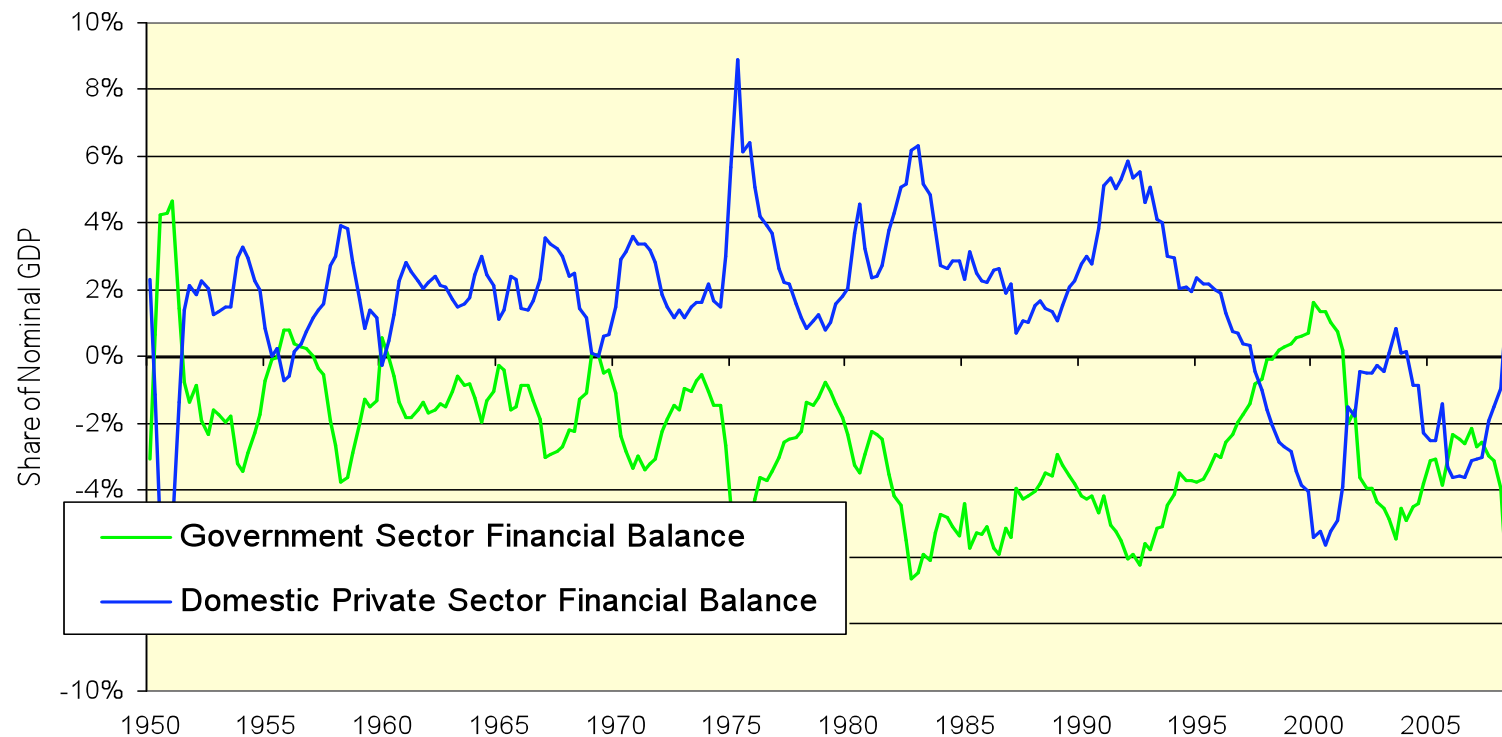
(billions)



Source: Haver Analytics

Hanging Ten over the Guardrails

For the US Private Sector to Net Save,
Another Sector Must Deficit Spend



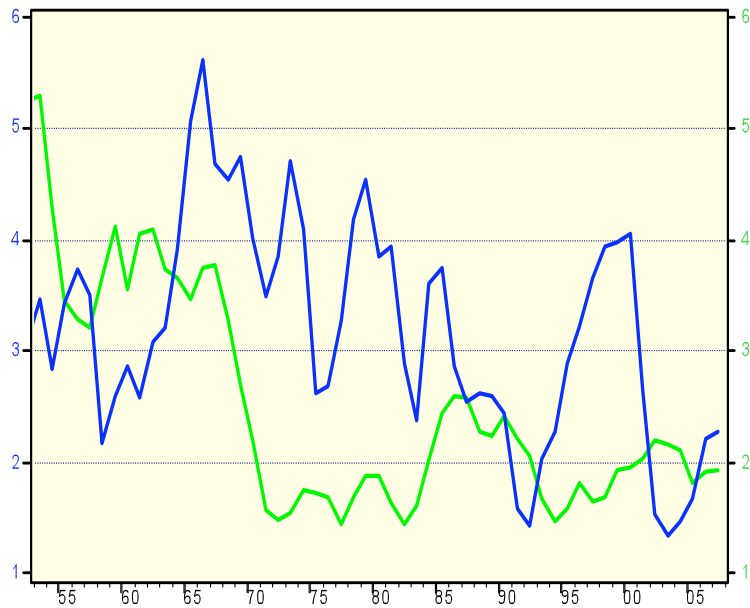
Fiscal Alternatives: Triple Play

- Market fails in long run investment decision making
- Post bubble household saving shift
- Chronic trade deficit
- Return to the original Keynes: public investment as a long run stabilizer/driver of private growth
- Seed and pursue long run investment goals with large positive externalities
 - Energy Independence
 - Water Infrastructure
 - Clean Tech
 - Education

Withering Public & Private Capital Stock

Net Stock: Private Fixed Nonresidential Assets: Quantity Index
 % Change - Year to Year 2000=100

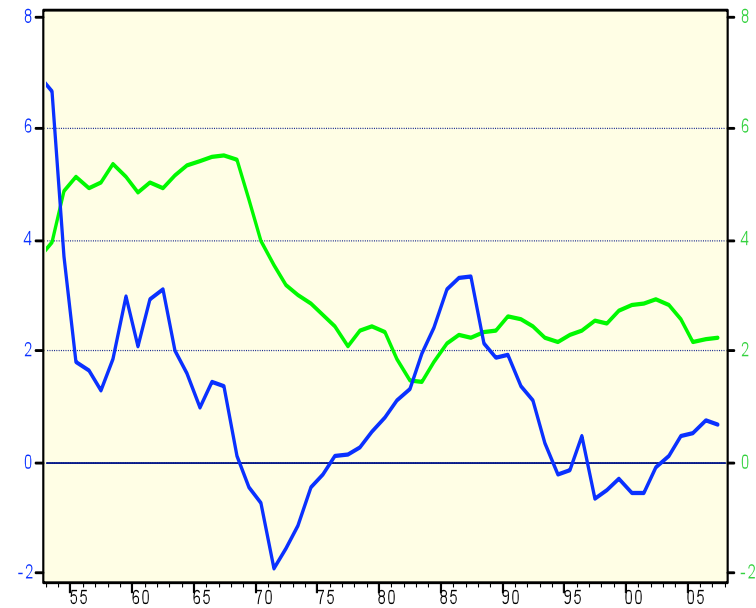
Net Stock: Government Fixed Assets: Quantity Index
 % Change - Year to Year 2000=100



Source: Bureau of Economic Analysis /Haver Analytics

Net Stock: Federal Government Fixed Assets: Quantity Index
 % Change - Year to Year 2000=100

Net Stock: State/Local Govt Fixed Assets: Quantity Index
 % Change - Year to Year 2000=100



Source: Bureau of Economic Analysis /Haver Analytics

Exit Strategy Challenges for QE

- Much of the Fed balance sheet will self-liquidate
- As recovery proceeds, Fed will “renormalize” fed funds rate and cease Treasury purchases
- Implicit UST yield ceiling will disappear
- No “natural” buyer with UST yields near historical lows
- Treasury yield curve likely to shift higher and steepen
- Mortgage rates may rise accordingly
- Recovery may be dampened or aborted

Execution Challenges for QE

- Fed purchases bonds to reduce private interest rates
- Historically low yields on UST reduce private portfolio preferences for bonds
- Fed has to escalate UST purchases to maintain implicit yield ceiling (Fed creates liquidity trap for bonds)
- Also, as Fed balance sheet expands, “monetarist” investors add inflation hedges
- Rising commodity prices “confirm” investor inflation fears
- Since energy, metals, ag land are inputs to production, adverse AS curve shift could prolong recession

Reorienting Monetary Policy

- Inflation stability is not a sufficient condition for financial stability
- Financial stability may be a necessary condition for inflation stability
- The Fed was born out of an episode of financial instability, the Panic of 1907
- G 20 agreement to reposition BIS Financial Stability Forum is a 1st step
- Stock/Flow coherent macro is essential to any serious financial stability analysis



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"For if we consistently act on the optimistic hypothesis, this hypothesis will tend to be realized; whilst by acting on the pessimistic hypothesis we can keep ourselves for ever in the pit of want."

*John Maynard Keynes
Preface Essays in Persuasion
November 8, 1931*