

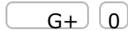
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Economic rebalancing and central bank's voodoo doctors

How many times have policy makers and central bankers opined that recovery is around the corner?

By: [Anindya Banerjee](#) | Updated: January 31, 2016 5:29 PM



What is money supply? It is a combination of credit and cash in the economy. In modern times credit is the biggest component of total money supply. (Reuters)

Have you ever seen a “quack” perform medical cure or a “voodoo doctor” in action? If you have not observed such a spectacle, then there is nothing to feel left out, because we all can experience it through the mastery of economic quack show from the so called “stewards of central banking”. Being in the financial markets for the last decade and a half, and observing the most glorified central bankers go about policy making, one should by now realize how clueless and stubborn they are. In fact it is a lethal combination, being clueless and also being stubborn. If one is just clueless and ignorant, then there is a hope. The hope is that the person may learn from his or her own mistakes. However, if the same person ends up being a pig-headed egoist then there is no salvation. Albert Einstein is widely credited with saying “The definition of insanity is doing the same thing over and over again, but expecting different results”. Bank of Japan proved Mr. Einstein right; they launched another monetary stimulation last Friday, hoping to turn around the Japanese economy for good. Honestly I have lost count of how many times they have eased over the past 25 years.

Source: FT, JP Morgan & WSJ

We are in the 9th year running since the last beginning of economic rebalancing, which began with financial crises in 2007. How many times have the policy makers, central bankers from both sides of Atlantic and in the major economies in EMs opined that recovery is around the corner? Economic projections from agencies like IMF have ritualistically forecast a “hockey stick” like recovery, only to start revising the hockey stick graph down to reality and then rinse and repeat it for the next year. Why have they been so off the mark, so consistently? If someone is so consistently wrong, one should just start doing exactly opposite, arithmetically it should mean a change of luck for good.

Central banks have a strange belief that if an economy is a simple machine with so much homogeneity, that one can like clockwork get desired outcome by turning a few levers. They address inflation like one would approach temperature of a liquid. Just turn on the gas for some time, and we can get the inflation right around our hypothetical level which is just right. First of all, their definition of inflation is extremely myopic. Inflation is an increase in price levels in the economy. Inflation can be in anything. Inflation can be in wheat, in iPhones, in houses, in financial assets and also in wages. The causes of inflation can be also numerous. If there is drought, prices of certain agro

commodities are going to rise. Similarly, if there is a strike in a copper mine, copper prices may also rise. Therefore, the cause of inflation cannot be defined by a single factor. However, there is another major cause of inflation in the economy, which can affect the wide basket of goods, services and assets in the economy, is the amount of money supply in the economy. It is this lever of inflation which should concern the central bankers.

When greater amounts money, chases lesser and lesser amount of goods and services and/or assets in an economy, what you get is price increase. That is your inflation. What is money supply? It is a combination of credit and cash in the economy. In modern times credit is the biggest component of total money supply. Credit is created out of thin air. Credit can be created between any two parties in the economy. Commercial banks are the biggest originators' of credit and they need no deposit money to create credit. Did that startle you; banks do not need deposit to lend? If so, I would suggest the following paper from Bank of England: (Click to read)

Therefore, the key to understanding economy is to understand credit. Economies expand and contract over long and short term, due to the expansion and contraction of credit in the economy. It is like a cyclical rhythm, much like the natural cycles of day and night.

Between 1980 and 2007, there was an unprecedented boom in general economy as well as in asset markets. The boom was largely driven by explosion in leverage in the economies and some enhancement in productivity. The model was simple, increased globalization, allowed world savers and consumers to interact seamlessly. Some countries in the west, like Germany and many in the emerging market space, like China, Japan, Australia and Middle East etc, became the net producer economies. They produced goods and services, which the world needed. Their domestic consumers were suppressed to allow greater economic benefit to be passed on to producers. The end result was a massive net surplus or savings being generated. The massive amount of savings had little scope being absorbed in their own economies. It flowed out into the financial assets and hard assets. It created a boom in asset prices, leading to income and wealth buoyancy around the world.

Consumers in the world, like Americans or southern nations in the Euro zone, participated in this leveraged boom. Greater and easier access to credit and the simultaneous asset boom, lead to debt driven consumption. As consumption rose, so did debt. The virtuous cycle of savers and consumers finally reached its inflexion point in 2007-12, with the debt crises in the consumer nations. Debt crises caused a reversal in investment demand around the globe, in both, physical assets as well as financial assets. If investment demand starts to fall then savings should also begin to fall as well, as economic identity that is savings should equal investment at a global level has to hold. However, for savings to fall, the major savers, the rich, need to start consuming more. However, rich have lower propensity to consume. Every incremental Dollar they earn, they end up saving more and spending less. Therefore, if the wealthy would not spend, then something has to happen to force savings to decline. Economic activity starts to slow and unemployment rise, assets prices decline, this brings about the needed economic rebalancing.

Since 2007 and 2008, what we are witnessing is that economic rebalancing process in motion. Governments and central bankers around the globe in their zeal to do something have launched various kinds of measures to counter the deleveraging cycle. However, they have only managed to prolong it. For example, China not willing to adjust to the reality of a deleveraging world in 2007-2012, decided to launch its own debt driven investment boom. The investment drive was epic in scale and so has been the subsequent debt accumulation. The problem is a chunk of that capacity is simply useless, which is now unable to generate return to pay down the debt. The end result is a creation of a Ponzi economy, where more and more producers simply borrow to pay interest on debt. Now they have no choice, but to begin reducing debt or else, a financial crises-led hard stop would become inevitable. A glance through the data available on credit creation in the economy shows the following:

“China’s outstanding total social financing increased at the end of 2015. A statement on the central banks website showed on Thursday, that the country’s outstanding total social financing at the end of December stood at 138.14 trillion Yuan, a 12.4 percent rise from a year earlier. The total social financing aggregate is a broad measure of credit extended to the economy that includes bank loans and non-bank credit.”

Now we need to estimate what could be the range of nominal GDP growth in China. Ignore the official statistics, let us assume that the actual nominal growth could be anywhere between 0-4%. Remember the producer sector has been in deflation since 2012, now the PPI is running at nearly negative 6%. China has added total credit of around USD 2.4 trillion, according to the TSF data, in 2015. Though TSF does not encompass all forms of credit creation in the economy but it can be used as proxy for trend in credit creation. The total stock of credit within the Chinese is anywhere between \$30-35 trillion. Therefore a growth of \$2.4 trillion or more addition credit during 2015, means that total stock of credit may have at least grown by 7/8%, much faster than the nominal growth in the economy. There lies the problem for China, credit is still growing too fast for the economy to be able to absorb productively. In his article in FT, George Magnus, aptly said, "China's chief vulnerability, and the main factor driving the tendency towards the increasingly fragile balance sheets that underlie the series of interrelated financial-market disruptions that began seriously in June 2013, is the inexorable rise in debt, and any analyst that fails to come to grips with the problem of excess credit is simply wasting his time"(Read article)

Therefore, we need to wait and see how soon Chinese policymakers eventually realize their responsibility and start rebalancing the economy in two ways, which is in sync with the rebalancing underway around the global economy. They need to allow : (1) Debt levels to come down (2) Allow consumers to become a greater share of the economy. Both of these would cause GDP growth to remain weak for many years but the transition will be healthy. The steps that is needed or will be forced by market forces can be either deflationary inflationary. China needs to ensure a proper mix of two, to prevent major crises from erupting. As an important part of the inflationary rebalancing, they need to have to have an easy monetary policy and weaker exchange rate. However, this rebalancing process in China is being threatened by the massive amount of leverage and bad assets in the system and the currency war in the world.

Currency war has just become even more fever pitched, as two major producer currency blocs have announced even more weaker exchange rate policy to import demand from a weak global economy, they are European Central Bank and Bank of Japan. They are muddying the waters for China. China is however, in two minds to respond, as the falling Yuan is causing stress in the stock market, corporate and

financial system. Chinese corporates have pledged trillions of Yuan of stocks to secure funding and the retail individuals have too directed their wealth over there. A weak Yuan is not only causing weak stock prices, which in turn can emerge as a margin call on the corporates, who have pledged their stock, it will also lead to more negative wealth effect on consumers. At the same time, unhedged FCY hot money investment in the economy will start to panic more, causing financial stress to propagate through the financial sector and corporate sector. Chinese policymakers are in a major fix. They need to adopt a easy money policy and weak exchange rate, but they also need to contend with its ill effects.

Before we conclude, let us touch upon the rupee market. [Indian rupee](#) managed to stage a comeback over the last day of the week. It strengthened from 68.26 levels to 67.79 on spot. Rupee was major gainer against yen, euro and pound too. Over the next week, we expect Indian rupee to remain ranged between 67.50 to 68.20 on spot but gain further ground against euro, pound and yen.
