DEBT DELEVERAGING: IS THIS THE BIG ONE?

Agenda

1. Bubbles
   a) Classifying
   b) Identifying
   c) Conditions
2. The Crash
3. Policy Responses

Tim Fuller
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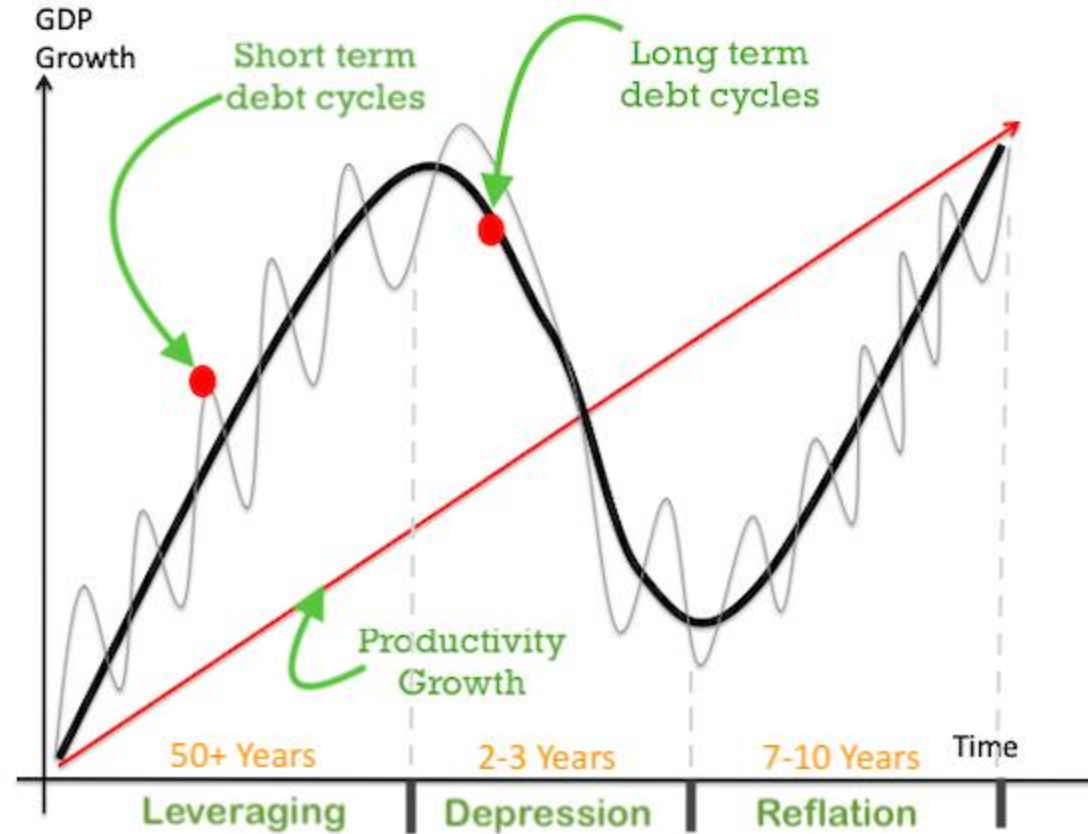
Overview:

What is a debt cycle



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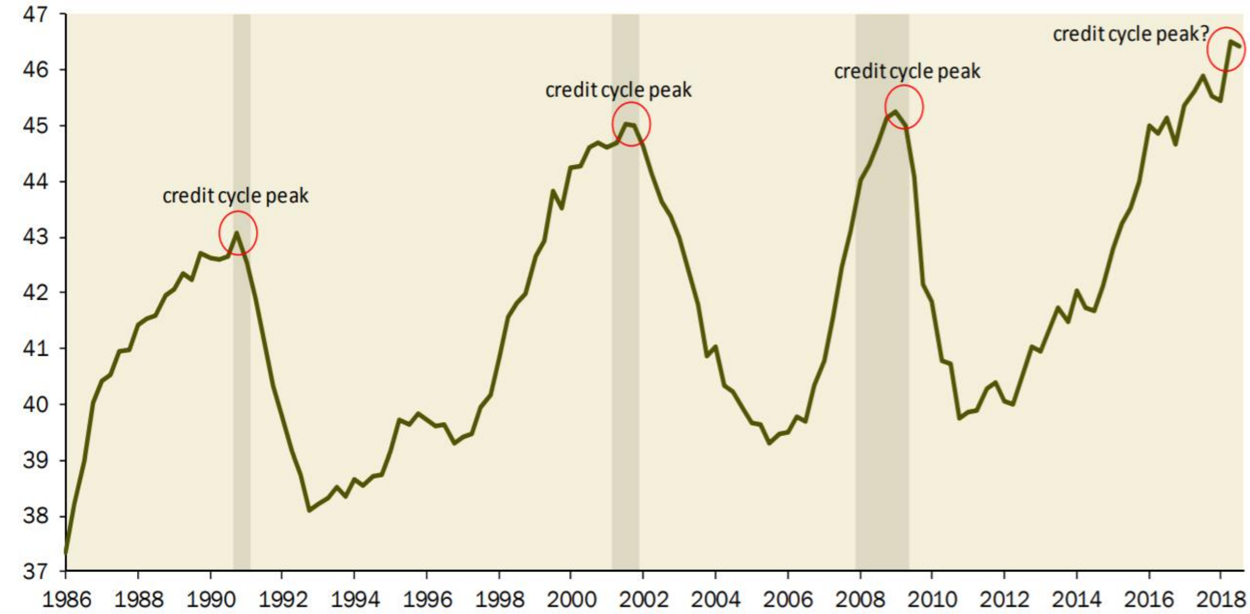
Overview:

Three types of debt



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Overview:

7 Stages

Nominal Short Rate

1 | 2 | 3 | 4 | 5 | 6

6%
5%
4%
3%
2%
1%
0%

Tight

Easy

-60 -48 -36 -24 -12 0 12 24 36 48 60 72 84

Early Part of the Cycle (1)

Bubble (2)

Top (3)

Depression (4)

Beautiful Deleveraging (5)

Pushing on a String/ Normalization (6)/(7)

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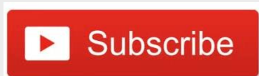
Bubbles:
Classifying

1. Inflationary or Deflationary

2. Long Term or Short Term



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Bubbles:
Identifying

1. Self Reinforcing
2. New Financial Instruments
3. Distribution of Credit
4. Checklist

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Bubbles:
Identifying

Applying the Framework to Past Bubbles

		USA 2007	USA 2000	USA 1929	Japan 1989	Spain 2007	Greece 2007	Ireland 2007	Korea 1994	HK 1997	China 2015
1	Are prices high relative to traditional measures?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
2	Are prices discounting future rapid price appreciation?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
3	Are purchases being financed by high leverage?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	N/A	Yes
4	Are buyers/companies making forward purchases?	Yes	Yes	N/A	Yes	No	Yes	No	Yes	Yes	No
5	Have new participants entered the market?	Yes	Yes	N/A	Yes	No	Yes	Yes	Yes	N/A	Yes
6	Is there broad bullish sentiment?	Yes	Yes	N/A	Yes	No	No	No	N/A	N/A	Yes
7	Does tightening risk popping the bubble?	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes	Yes

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Bubbles:
Conditions

Conditions During the Bubble

		Change During Bubble	Range
1	Debt growing faster than incomes	40%	14% to 79%
	Debt growing rapidly	32%	17% to 45%
	Income growth high but slower than debt	13%	8% to 20%
2	Equity markets extend rally	48%	22% to 68%
3	Yield curve flattens (SR - LR)	1.4%	0.9% to 1.7%

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Bubbles:
Conditions

In many cases, **monetary policy helps inflate the bubble rather than constrain it.**

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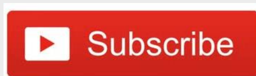
The Crash:
Tipping Point

- Where is the tipping point?
- Flattening Yield Curve
- Domestic Conditions
- External Shock



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The Crash:
Depths

- More leverage, higher prices = less to prick the bubble
- Willingness to spread the pain
- Zero lower bound

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Policy Responses:

Tactical

- **Lower Interest Rates**
- **Curtail panic,** guarantee liabilities
- **Provide liquidity.** Increase collateral taken
- **Support the solvency of systemically important institutions.** Accountancy rule changes?
- **Recapitalize/nationalize/cover losses of systemically important financial institutions.**
- **Victim Narrative**

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Policy Responses:

Typical

Frequency of Levers Used to Manage Debt Problems (% of Cases)

Liquidity Support	Emergency Lending/Liquidity	88%
	Bank Liability Guarantee	58%
	Bank Holiday/Deposit Freeze	21%
Address Insolvent Lenders	Bank Restructuring/Mergers	81%
	Recapitalization	73%
	Nationalizations	60%
	Losses Imposed on Depositors	29%
Dispose of Bad Debts	Through Asset Purchases and Transfers	44%
	Through Centralized Asset Management Co's	38%
Sovereign Default/Restructuring		35%
IMF Program		52%

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Policy Responses:
Strategic

- Austerity
- Money Printing
- Debt Defaults
- Redistributing Wealth

Policy Responses:

Strategic

USA 3Yr Money Growth (%GDP Ann)

4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
-0.5%

Monetizaton begins

Monetization begins

1910 1920 1930 1940 1950 1960 1970 1980 1990 2000 2010 2020

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Policy Responses:

1. Bubble

Good Policy

- Central banks consider growth in debt and its effects on asset markets in managing policy. If they can prevent the bubble, they can prevent the bust.
- Central banks use macroprudential policies to target restraints in debt growth where bubbles are emerging and allow debt growth where it is not excessive.
- Fiscal policies are tightened.

Bad Policy

- Big bubbles are fueled by speculators and lenders over-extrapolating past successes and making further debt-financed investments, and by central banks focusing just on inflation and/or growth and not considering debt bubbles in investment assets, thus keeping credit cheap for too long.

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Policy Responses:

2. Top

Good Policy

- Central banks constrict the bubble either with the control of broad monetary policy or with well-chosen macroprudential policies and then ease selectively (via macroprudential policies).

Bad Policy

Central banks continue to tighten well after bursting the bubble.

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Policy Responses:

3. Depression

Good Policy

- Central banks provide ample liquidity, ease short rates quickly until they hit 0%, and then pursue aggressive monetizations, using aggressive targeted macroprudential policies.
- Governments pursue aggressive and sustained fiscal stimulus, easing past the turn.
- Systemically important institutions are protected.

Bad Policy

- Central banks are slower to cut rates, provide more limited liquidity, and tighten too early. They also wait too long to pursue aggressive monetization.
- Governments pursue austerity without adequately easing.
- Systemically important institutions are left damaged or failed.

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Policy Responses:

4. Deleveraging

Good Policy

Bad Policy

- Reflations begin with aggressive monetizations through asset purchases or big currency declines, enough to bring nominal growth above nominal rates.
- Stimulative macroprudential policies are targeted to protect systemically important entities and to stimulate high-quality credit growth.
- Nonsystemically important institutions are allowed to fail in an orderly way.
- Policy makers balance the depressive forces of defaults and austerity with the reflationary forces of debt monetization, currency declines, and fiscal stimulus.

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Policy Responses:

4. Deleveraging

Bad Policy

- Initial monetizations stutter and start. Asset purchases are more muted and consist more of cash-like instruments rather than risky assets, so that purchases don't produce a wealth effect. Stimulation of the central bank is undermined by fiscal austerity.
- Overindebted entities are protected even though they are not systemically important, leading to zombie banks and malaise.
- Ugly inflationary depressions arise in cases where policy makers allow faith in the currency to collapse and print too much money.

Policy Responses:

5. Pushing on a string: Monetary Policies

- Interest Rates
- Quantitative Easing
- Helicopter Drops
- Fiscal/Monetary tensions

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Policy Responses:

6. Normalisation

- 5-10 years
- Equity premiums remain high

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Policy Responses:
Investor Notes

- The sooner the better
- Not typically inflationary
- Note disappearance of credit, needs to be replaced
- AUD to fall

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