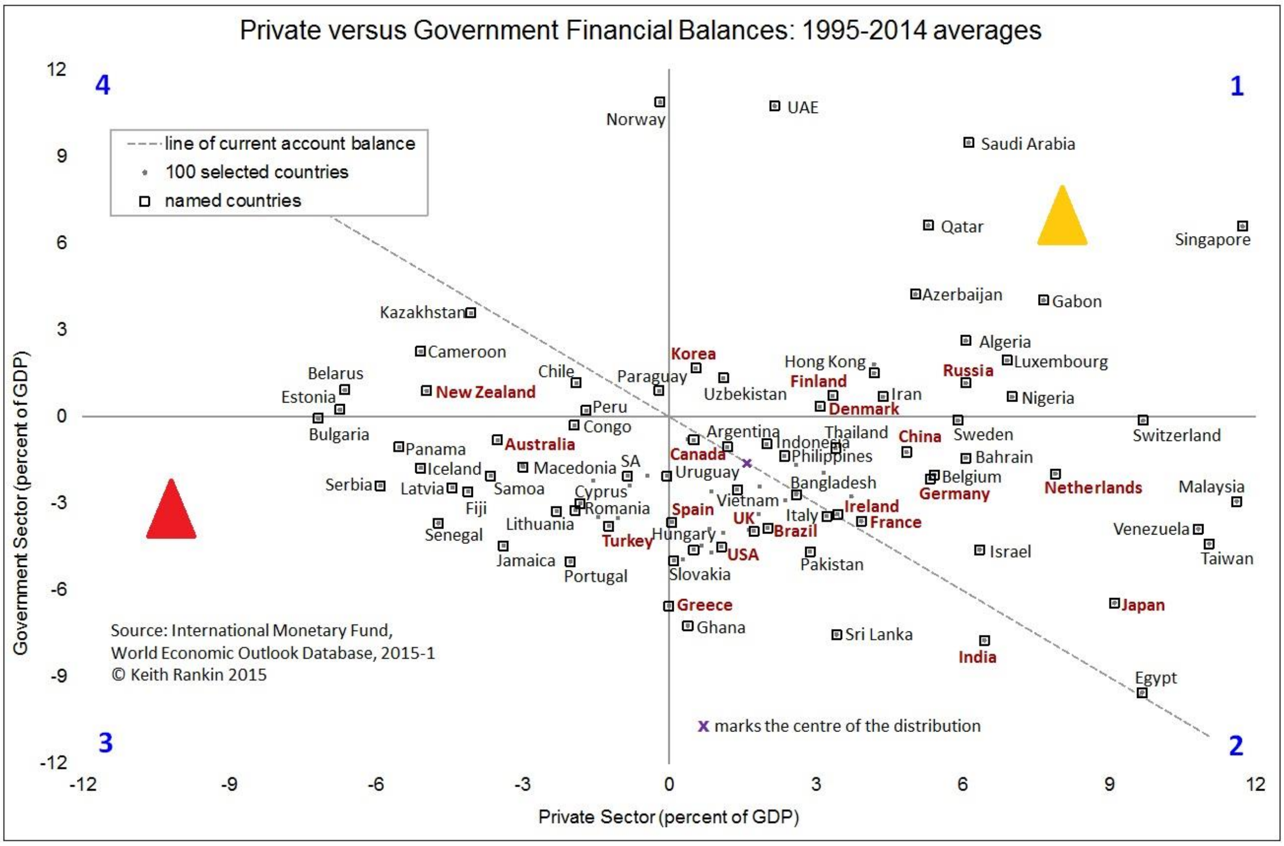
Predicting the World Economy through Financial Balances

Keith Rankin, 8 October 2015

In my most recent [Charts for this Week](#) on *Evening Report*, I have published charts of average private sector and government financial balances (surpluses/deficits) for a wide range of countries for two decades of financial excess ([Spread of Financial Balances by Country, 1995-2014](#)), and of shifts of selected countries from before to after the global financial crisis ([Shifts of Country Financial Balances before and after the Global Financial Crisis](#)).

While these long-term averages represent the 'financial personalities' of these countries, the chart of shifts shows important changes that have resulted from the 2008-09 world crisis.



[Spread of Financial Balances by Country, 1995-2014](#)

Country 'Financial Personalities'

In a highly stable world economy, all balances would be close to zero, on both the private (horizontal) and public (vertical) axes. (If the world economy is growing, then countries should be spread in Quadrant 2 along the line of current account balance, from the 0,0 position to the +4,-4 position. If countries grow at 4% per year, then government annual deficits at 4% of GDP are quite stable.)

The fact that financial personalities show such diversity suggests that the world economy (probably since the 1980s) has a repeated tendency to become financially unbalanced, with crises ('hard-landing' corrections) likely to occur five or more times in a person's lifetime. Soft-landing corrections (controlled 'deleverage') can occur if most (preferably all) countries can recognise the danger signs and choose to adopt rebalancing financial behaviours to pre-empt these crises.

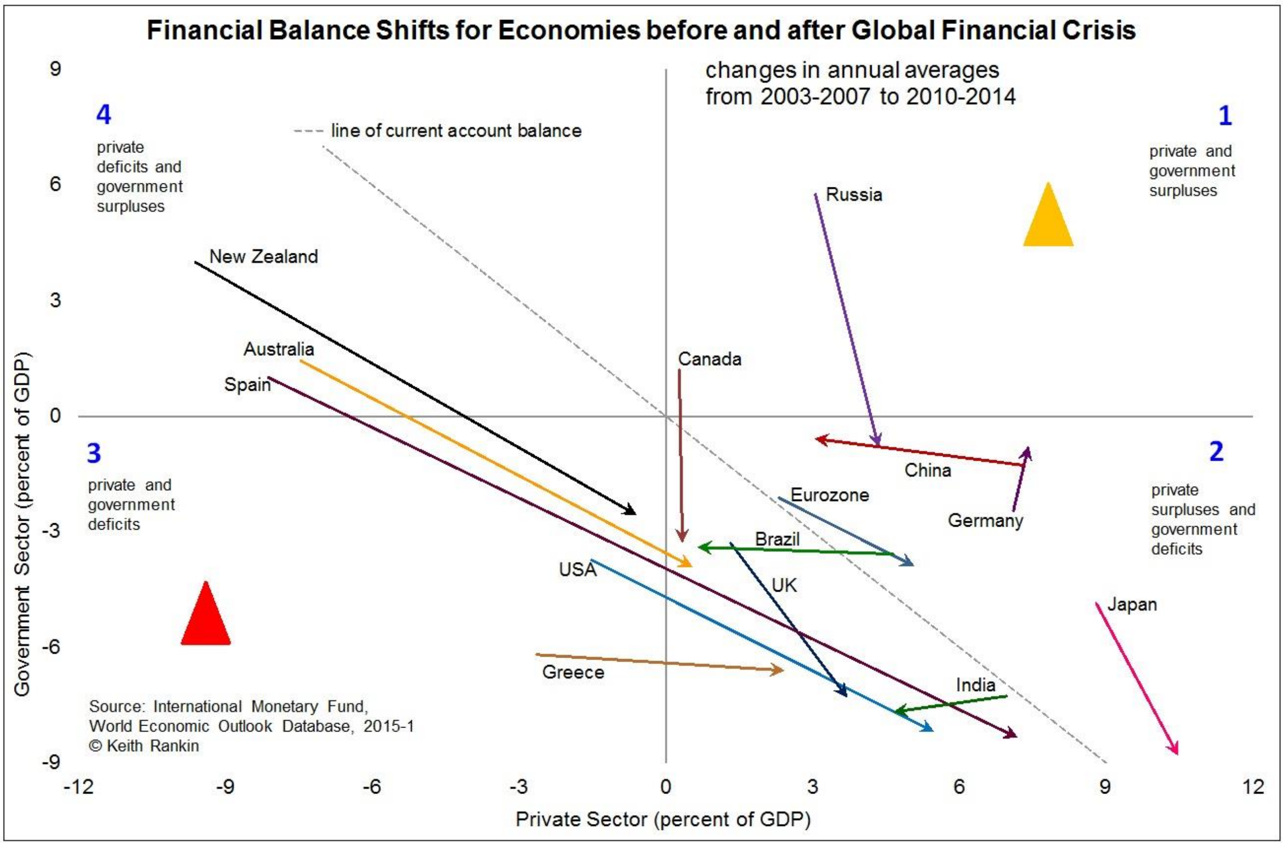
Looking at the [Spread of Financial Balances by Country, 1995-2014](#), the most unstable positions are marked by the gold 'money mountain' (that represents making and hoarding lots of money, what many people believe constitutes economic success) and the red 'debt mountain'. For systemic reasons – the zero-sum requirement that at all times as many countries are on the left of the 'line of current account balance' as are on the right – when some countries manage to cluster around the money mountain then other countries must be clustered around the debt mountain. The process of repayment of debts by those in the red quadrant to their creditors in the gold quadrant, would mean a switching of position during this deleveraging phase. (A country repaying debts is running financial surpluses, whereas a country being repaid is running deficits.) The problem is that it requires all countries to place themselves outside their financial comfort zones; like requiring a reversal of yang and yin every decade or so.

Evaluating Intent

One key dynamic of intent this decade is governments seeking to raise their financial balances. This is a process known as 'government austerity' or 'fiscal consolidation'. On the chart we can visualise this as governments – through their fiscal policies – seeking to move up the chart. They can only actually achieve this 'upwards intent' if other countries accommodate by moving down or moving left.

Most neoclassical economists assume (though usually without supporting evidence) that upwards movements by governments will induce leftward movements of their private sectors. However the global financial crisis itself brought about a sharp rightward movement in the world's private sectors (increased thrift, debt repayment; decrease in new private sector debts incurred). Further, fiscal consolidation tends to aggravate private-sector caution. Business confidence increases when governments are good customers, and decreases when governments as customers are stingy or unreliable.

In essence any intent anywhere to move one's own private balances to the right (or one's government's balances upward) has a depressive effect on the economy, raising unemployment if enough other people or businesses share that intent. Conversely, any intent on the part of private parties to decrease their financial balances (ie spend and borrow more, move leftward on the chart) has a stimulatory effect on the global economy, as does any attempt by governments to decrease their financial balances (ie to increase their fiscal deficits), downward movement on the chart.



Shifts of Country Financial Balances before and after the Global Financial Crisis

The world pattern for this decade is revealed in part by the second chart (Shifts of Country Financial Balances before and after the Global Financial Crisis). We know that the general intent on the part of governments this decade has been to raise their balances (move up the chart). We see that only Germany has achieved that intent. The bigger story has been the private intent to move right, offset by induced (largely unintended) increases in government deficits; ie by government balances that have decreased despite policy intent to raise those balances. The secondary story is that of three of the four BRIC economies (Brazil, India, China) whose private balances have shifted to the left, counter to the global movement post-crisis. It is these countries' willingness to borrow or spend that 'saved' the world capitalist economy in the last half decade. Brazil and China are now experiencing the 'economic wobbles' – as are Russia and Canada, two other important accommodators. These countries are now unable to continue offsetting the rest of the world's miserliness.

A Soft landing?

It is approaching time to action the soft-landing strategy to stabilise the global economy. I don't see it happening. The way the Eurozone is structured at present means that Germany can hardly discontinue its 'gold mountain' quest (see my Germany, the Eurozone and Mercantilism, 29 Sep 2015). The chance that Germans are suddenly going to switch into a spendthrift strategy – which is what the world needs of it – is close to zero. Increased American spending has become the main stabilising factor in the world in 2015, but that is likely to fall away sharply in 2017, with whatever new administration takes over then.

The most likely future for the world economy in the final third of this decade is another hard-landing, with lots of private debt write-offs, another big private sector spending freeze (shift to the right), and ever bigger government deficits required to contain the damage.

Japan got into this financial dynamic first, in the 1990s. Whither the global economy? Watch Japan. The good news is that Japan's economic situation is not nearly as bad as most western economists and financiers think it ought to be. Government-facilitated spending in Japan is the solution, not the problem.
