Excess Debt and Deflation = Depression

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Irving Fisher (1867 – 1947) was perhaps the most noted economist of his day. The Concise Encyclopedia of Economics calls him "one of America's greatest mathematical economists and one of" its clearest writers. He earned special acclaim for his work on monetary and statistical theory, policy, index numbers, econometrics, and the distinction between real and nominal interest rates.

He's also remembered for having made one of the worst and most ill-timed ever stock market calls that cost him his reputation and millions in the subsequent crash – on October 17, 1929 (a week before Black Thursday) when he said "stock prices had reached what looks like a permanently high plateau."

He made the call in a climate much like mid-2007 – one of economic growth and easy credit producing speculative excess, bubbles, and the belief that good times would continue unabated. They didn't then and never do but only in hindsight are those lessons learned.

Investors forget what Keynes once taught when he said: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise become the bubble on a whirlwind of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." So it was in the 1920s, in the 1990s, and post-2000, but even Keynes was wrong in 1927 when he said: "We will not have any more crashes in our time."

After the 1929 crash and deepening downturn, Fisher analyzed what happened and in 1933 wrote his "Debt-Deflation Theory of Great Depressions." It raised disturbing questions about the roles of the Fed, Wall Street and Washington, and, as a result, was largely ignored. Given the book's relevance today, this article reviews the most significant of his "49 tentative conclusions."

He believed two major factors cause depression – excess debt (based on easy credit and loose lending practices) and deflation, especially in combination. Others also affect business cycles, but they're secondary to the main ones.

Financial expert and investor safety advocate Martin Weiss recalls what his father, Irving, taught. He lived through the 1920s, the 1929 crash, and Great Depression and tracked data as it was released "to figure out what might happen next. (He) was an analyst and that was (his) job."

"Years later economists like Milton Friedman and (his) young friend Alan Greenspan (tried) to decipher what went wrong. They concluded that it was mostly the government's fault, especially the Federal Reserve. They developed the theory that the next time we're on the brink of depression, the government has got to step in and nip it in the bud. Bah! Those guys weren't back there back then (like Irving was)."

He "saw exactly what the Fed was doing in the 1930s: They did everything in their power to stop the panic. They coddled the banks. They pumped in billions of dollars. But it was no use. They eventually figured out they were just throwing good money after bad. The real roots of the 1930s bust were in the 1920s boom. That's when the Fed gave (loads of) cheap money to the banks." They loaned it to brokers who loaned it to speculators, and a bubble was created and imploded.

"In 1929, our economy was a house of cards. It didn't matter which cards we propped up or which ones we let fail. We obviously couldn't save them all. So no matter what we did," and the longer we denied reality, "the worse it was for everyone. The sooner we accepted it, the sooner" a real recovery was possible. Fisher understood it also and wrote about it in his book.

Besides the early years of the Great Depression (before its full impact or length could be known), he used the Panic of 1837 as an example. It was caused by heavy demand for loans to buy land, build businesses, and invest in the country's development. Prices began rising, economic strains built up, and a speculative bubble developed that burst in New York on May 10 when every bank stopped payment in specie (gold or silver coinage). A five year depression followed. Many banks failed, and unemployment soared to record levels.

Andrew Jackson was blamed for requiring that gold and silver currency (not fiat paper) be used to pay for government land. Also for not renewing the Second Bank of the United States charter and withdrawing government funds from the bank. Most historians believe it but more recent scholarship cites other causes instead. What's not disputed was the speculative excess that came to a painful end.

The Panic of 1857 ended the boom years following the 1846 – 1848 Mexican War. It gave America undisputed control of Texas, established the US – Mexican border at the Rio Grande River, seized the present-day states of California, Nevada, Utah, and parts of Colorado, Arizona, New Mexico, and Wyoming, and opened this vast new area to speculation and development. Much of it was to expand railroads. It proved unsustainable and led to crisis.

The failure of the New York branch of the Ohio Life Insurance and Trust Co. was the proximate cause. It ignited panic as a result of massive embezzlement and heavy losses on depreciated railroad investments. Eroded public confidence took over, setting off a chain of events as follows:

— investment money dried up;

— British investors pulled out of American banks because of fears of their unsoundness;

— grain prices fell and heavily impacted rural areas;

— inventories piled up in warehouses;

— massive layoffs followed;

— railroads failed because of over-building;

— 5000 businesses failed within a year; and

— land prices collapsed ruining thousands of investors.

A further blow was losing 30,000 pounds of San Francisco Mint gold at sea intended for eastern banks. Confidence eroded further in the government's ability to back paper currency with specie. In October, a bank holiday in New England and New York failed to avert runs in the states. Panic spread to Europe, South America and Asia and, while brief, didn't fully abate until the 1861 War Between the States (the American Civil War).

The Panic of 1873 (near the onset of the Gilded Age) was called "the real Great Depression" by some. It began eight years after war ended and started a six-year depression until 1879. It was triggered by the Vienna Stock Exchange crash in May (the so-called Grunderkrach or "founders' crash"), then spread to America in the fall.

The key event was the failure of Jay Cooke and Company, the nation's preeminent investment bank, the principal backer of the Northern Pacific Railroad, and holder of most government wartime loans. It triggered a series of events that followed.

The New York Stock Exchange closed for 10 days. Credit dried up. Banks demanded payment of their loans. Investors rushed to sell stocks. Foreclosures increased, many banks failed and most major railroads. Factories then closed, unemployment soared, and many reasons were cited as the cause – post-war frenetic growth, unregulated speculative abuse, and the extreme overbuilding of the railroads causing panic and depression.

Another factor was also involved. Like today's Wall Street banks, the railroads crafted complex financial instruments promising a fixed return. Few investors understood them or that in case of default they'd get nothing. Initially the bonds sold well, but fell after 1871 when investors doubted their value. As prices weakened, railroads assumed short-term bank loans to keep expanding. When rates skyrocketed in 1873, they were in trouble, and when Jay Cooke (in September) defaulted on his debt the stock market crashed. Hundreds of banks failed, the panic continued for five years and even longer in Europe.

What harmed the public, banks, and railroads created opportunity for well capitalized industrialists like Rockefeller, Carnegie, and Cyrus McCormick. It let them buy assets at fire-sale prices, began the so-called Gilded Age, and triggered the onset of powerful business concentration.

Small factories and businesses were out of luck. Many shut down. Tens of thousands of workers lost jobs. Unemployment in New York alone reached 25%. Workers demonstrated in Boston, New York, Chicago and elsewhere demanding work, and some of the most violent strikes in American history followed. One was a nationwide railroad action in 1877 in which mobs destroyed hubs in Pittsburgh, Chicago, and Cumberland, MD. Times were even harder in Central and Eastern Europe and lasted longer.

The panic of 1893 caused another depression until 1897 that according to some was as severe or worse than the 1873 crisis. Various factors were blamed – railroad overbuilding, shaky financing, the usual kinds of speculation, and a run on the gold supply among others.

In early May, the New York stock market fell sharply and crashed by late June. A severe credit crisis followed. About 15,000 businesses, 600 banks and 74 railroads failed, and unemployment tripled from one to three million by mid-1894.

Workers responded in the first ever march on Washington. Businessman populist Jason Coxey led his “Coxey’s Army” (numbering about 500) from Massilon, Ohio (beginning March 25, Easter Sunday) to the nation’s capital to demand jobs and present Congress with “a petition with boots on.” Local police intervened. The marchers were disbanded. Coxey was arrested, spent 20 days in jail for disturbing the peace and violating a local ordinance prohibiting walking on the grass, was never charged, and then released.

Other panics followed in 1903, 1907, and then the big one in 1929 – the Great Crash on three days – Black Thursday (October 24), Black Monday (October 28) and Black Tuesday (October 29) – triggering bank failures and the Great Depression throughout the 1930s until WW II ended it.

Fisher discussed its cause and attributed it to debt and deflation. He also explained “cycle theory” – the instability around equilibrium and the influence of “forced” (like seasons) and “free” (self-generating like waves) cycles. He stated:

“Exact equilibrium….is seldom reached and never long maintained. New disturbances are….sure to occur, so that….any variable is almost always above or below ideal equilibrium.”

“….at most times there must be over or under-production, over or under-consumption, over or under spending, over or under-saving, over or under investment, and over or under everything else.” Believing in perfect equilibrium is like assuming the Atlantic Ocean is without waves.

“In the great booms and depressions, each of the above-named factors has played a subordinate role as compared with two dominant factors, namely over-indebtedness to start with and deflation following soon after; also that where any of the other factors do become conspicuous, they are often merely effects or symptoms of these two.” This is key.

Fisher then discussed nine interacting factors under debt and deflation conditions that can lead to a Great Depression. Over-indebtedness leads to liquidation “through the alarm either of debtors or creditors or both.” The following “chain of consequences” follows:

(1) “Debt liquidation leads to distress selling and to

(2) Contraction of deposit currency, as bank loans are paid off, and to a slowing down of velocity of circulation.” Deposit and velocity contraction (from distress sales) cause

(3) “a fall in the level of prices, in other words, a swelling of the dollar.” If price declines aren’t “interfered with by reflation or otherwise, there must be

(4) A still greater fall in the net worths of business, precipitating bankruptcies and

(5) a like fall in profits.” That, in turn, causes

(6) “A reduction in output, in trade and in employment of labor. These losses, bankruptcies and unemployment, lead to

(7) Hoarding and slowing down still more the velocity of circulation.” Velocity refers to the

rate at which money circulates, changes hands, or turns over. Greater velocity means greater demand and faster growth. It's computed by dividing the output of goods and services (GDP) by the total money supply.

The above eight changes cause:

(9) "Complicated disturbances in the rates of interest, in particular, a fall in the nominal, or money, rates and a rise in the real, or commodity, rates of interest.

....debt and deflation go far toward explaining a great mass of phenomena in a very simple logical way."

Fisher explained that loose monetary policy causes over-indebtedness fueling speculation and asset bubbles that aren't sustainable. "Easy money is the great cause of over-borrowing. When an investor thinks he can make over 100 per cent per annum by borrowing at 6 per cent, he will be tempted to borrow, and to invest or speculate with the borrowed money. This was the prime cause leading to the over-indebtedness of 1929. Inventions and technological improvements (at the time) created wonderful investment opportunities, and so caused big debts."

Fisher then described "distinct phases" driving public sentiment:

(a) the prospect of "big dividends or gains in income in the remote future;"

(b) selling at a profit for a capital gain "in the immediate future;"

(c) "the vogue of reckless promotions, taking advantage of the habituation of the public to great expectations" or the notion that good times are self-sustaining, and

(d) "the development of downright fraud, imposing on a public which had grown credulous and gullible."

Fisher's debt, deflation and instability theory is summarized as follows:

(1) "economic changes include steady trends and unsteady occasional disturbances (that result in various type) cyclical oscillations;"

(2) among the "disturbances" are new investment opportunities;

(3) these among others create over-indebtedness;

(4) this "leads to attempts to liquidate;"

(5) "unless counteracted by reflation," these cause price declines "or a swelling dollar;"

(6) "the dollar may swell faster than the number of dollars owed shrinks;"

(7) as a result, liquidation doesn't liquidate; it aggravates debts, "and the depression grows worse instead of better;"

(8) extricating from this is either by bankruptcy or reflation through monetary and/or fiscal policies.

Like Keynes, Fisher believed that reflation should be limited and temporary, not long, sustained or extreme like under Greenspan and Bernanke. Otherwise short-term solutions cause much greater problems, now playing out and may become more severe ahead. As a per cent of GDP, total credit market debt is now double its 1929 level at about 350%. It's rising fast with continuing new new liquidity injections that show no signs of diminishing. Reportedly the Fed may now issue its own debt – an astonishing move if it happens as it will create unlimited debt amounts and leave the Fed unaccountable to no one for doing it.

As in 1873, 1929, and other financial panics, speculation has been rampant, much more extreme than earlier, and debt levels are unprecedented and growing. As a result, large banks are effectively insolvent, hoard cash, and won't lend. Credit is scarce. Households are too over-indebted to borrow. Lenders won't extend it anyway. Unemployment is skyrocketing, and the potentially greatest ever economic crisis is worsening – so much so that London-based GFC Economics predicts successive 2009 months of one million layoffs in the US.

And unprecedented-sized bailouts assure greater trouble ahead. Using inflation-adjusted numbers, Jim Bianco of Bianco Research said that bailout-related debt cost more than the following combined:

— the Marshall Plan – cost: $12.7 billion; inflation-adjusted cost: $115.3 billion;

— the Louisiana Purchase – cost: $15 million; inflation-adjusted cost: $217 million;

— NASA's Apollo human spaceflight program – cost: $36.4 billion; inflation-adjusted cost: $237 billion;

— the S & L crisis – cost: $153 billion; inflation-adjusted cost: $256 billion;

— the Korean War – cost: $54 billion; inflation-adjusted cost: $454 billion;

— the New Deal – cost: an estimated $32 billion; inflation-adjusted cost: an estimated $500 billion;

— the invasion and early months of the Iraq War (not the total war cost to date that's far higher) – cost: $551 billion; inflation-adjusted cost: $597 billion;

— the Vietnam War – cost: $111 billion; inflation-adjusted cost: $698 billion; and

— NASA since inception – cost: $416.7 billion; inflation-adjusted cost: $851.2 billion.

Total: $3.92 trillion compared to around $8.5 trillion in bailout funds allocated or pledged thus far with these numbers certain to go higher.

Will deflation and depression follow? Who can know, but Nouriel Roubini understands the seriousness of over-extended debt and explains the consequences of falling prices. It affects "the real value of nominal liabilities," and makes them rise "as do real interest rates once the nominal interest rate hits" zero. Hoarding cash and saving "instead of investing is thus self-reinforcing as (a) deflationary spiral takes hold."

He sees the threat of "stag-deflation (recession/ stagnation and deflation) and "debt deflation" that's "already forced the Fed into a liquidity trap (with investors preferring to hold cash) as the Fed funds rate is effectively close to 0% and an informal policy of 'quantitative easing' has already….flooded financial markets with over $2 trillion of liquidity" – now even more than when he wrote this in late November and, for the first time (on December 9), the Treasury sold $30 billion of four-week bills at zero interest. On July 31, 2001, they were auctioned for the first time, to be continued weekly along with regular 13 and 26-week bills. Back then, they yielded around 3.5%.

Roubini sees lots of negatives from current policies, even depression, but he doesn't predict it. He states: "Desperate times and desperate economic news require desperate policy actions." However "partially necessary" they may be, they'll "eventually lead to much higher real interest rates on the public debt and weaken the US dollar once this tsunami of implicit and explicit public liabilities and monetary debt (the result of rising twin fiscal and current account deficits) hits a world where the global supply of savings is shrinking. As most countries move to fiscal deficits (and reduce global savings), foreign investors (may) start to ponder the long-term sustainability of the US domestic and external liabilities."

With the economy "in free fall," debt obligations at unprecedented levels, and "stag-deflation" deepening, the worst of possibilities may unfold and spread contagion everywhere.

The Bank for International Settlements (the so-called central bank for central bankers) showed concern in its December Quarterly Review. It questions the soundness of near-zero interest rates that may disrupt money markets and "discourage banks from lending to other banks." It's also worried about the "scope and magnitude of the bank rescue packages (because) significant risks (from toxic debt have) been transferred onto government balance sheets" in amounts great enough to risk future default.

Only in time will we know, but the worst of possibilities are real, especially in America where debt levels are hugely unmanageable, yet they continue to be added to recklessly.

What will unfold and how it will end can't be known. The human fallout already is huge. It may end up overwhelming but not as fast as in the 1930s. According to Department of Commerce Bureau of Economic Analysis figures, GDP fell 26.6% between 1929 and 1933, personal income declined 25.7%, and consumption expenditures dropped 18.2%.

Given a three-decade US standard of living decline to the present, exacerbated by the intensifying current crisis (very likely to be protracted and deep), it's very possible those 1930s numbers may be matched or exceeded going forward. If so, it may just take longer before their full effects show up and are felt.

But look how big businesses are advantaged. Smaller ones will fail, and the giants will get even bigger through asset acquisitions at fire-sale prices. As they say, what goes around, comes around but much to the public's detriment as it always is.

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