The great debt bubble of 2011

JOHAN NORBERG
1 JANUARY 2011

Have our governments averted a financial disaster – or paved the way for one?

‘The worst of the storm has passed,’ declared Barack Obama at the start of last year, seeking to calm the fearful. For his part, Gordon Brown assured Britain that talk of tough years ahead was ‘simply not true’. Both men spoke of their resolve to cure their economies, and did not seem to mind using the same techniques that created the old bubble. Bank bailouts and massive stimulus efforts have indeed encouraged us to borrow, spend and speculate again. Bank interest rates have dropped to historic lows, bringing cheap credit to the housing market and the high street. The mood this year is one of cautious optimism. It would all be reassuring, were it not so eerily familiar.

In 2003, after the dotcom crash and the 11 September attacks had sent America into recession, everybody wanted the debt-fuelled consumer binge to continue. Not that they said so in terms. Euphemisms were deployed, then as now: there should be government ‘support’, a little touch of Keynes. The Nobel-winning economist Paul Krugman urged Alan Greenspan to ‘create a housing bubble to replace the Nasdaq [stock market] bubble’. The Fed chairman obliged, cutting interest rates to a new low. In Britain, base interest rates halved between 2000 and 2003. Money was as cheap as it needed to be to get everybody borrowing again, and returning to the market. House prices boomed. It looked like prosperity. Bubbles so often do.

Nothing is more dangerous than an idea when it’s the only one you have. There is a broad consensus that the financial crisis of 2007 was at least in part a result of record-low interest rates, huge deficits and large-scale credit-financed consumption. Today, governments across the world are trying to solve the crisis — by means of record-low interest rates, huge deficits and large-scale credit-financed consumption. This time, they are also using more novel means of creating easy money: bank bailouts, stimulus packages and quantitative easing. Once again, it has produced results: Christmas shopping was quite buoyant. But no one has asked how many of these Christmas shopping bills were paid with borrowed money.

For all the talk of austerity, governments everywhere plan to get through 2011 and beyond by borrowing like crazy. The world’s rich countries have increased their debt by some 50 per cent over the past three years, according to the IMF. Such statistics can too often seem meaningless, but during the British general election campaign David Cameron found a way to make them real. He unveiled a poster saying that a baby born today would owe £17,000 due to government debt. By his own estimates, that burden will rise to £21,000 within four years. Less than it would have been without the extra belt-tightening, to be sure, but a daunting figure none the less.

All governments are betting that they can keep borrowing such extraordinary sums at very low rates. But the markets may have other plans. Consider the evolution of this crisis. The crash happened because households consumed too much, sending their debts to the banks. The banks sent the debts to the governments — and, as we saw with Ireland, even governments might struggle to meet them. So they are sending their debts to the European Union. But to whom will the EU send the bills when its credit card is maxed out?

Greece and Ireland aren’t just illiquid, they are insolvent — and nothing is solved by taking new, bigger loans when they can’t pay the old ones. If Ireland or Greece default on their debt, forcing creditors to take steep losses, it might spook the markets and pull out a thread that unravels the garment.

Markets are lending billions to Spain (and Italy, Belgium, perhaps even France) because investors imagine that, while the countries themselves might be broke, someone else guarantees the investment. I am sure I was not the only one who was told by my bank that it was safe to invest in peripheral (i.e. Irish) European debt on the grounds that the EU would always step in rather than let them go bust. Sovereign bond markets panicked when Angela Merkel suggested that investors might one day have to bear some of their own losses.

If the defaults start — or if it dawns on markets that the European Financial Stability Fund doesn't have half of what it would take to save Spain, the world's ninth largest economy — then investors might rush for the exit. And this, for David Cameron and George Osborne, would produce some deeply unpleasant surprises. What would happen to the British banks that have lent more than \$110 billion to Spain, or the French banks that lent \$162 billion, or the German ones that lent \$182 billion?

This year is laden with risk for Europe's most indebted nations. The Spanish banks are already very shaky and — even in the best of circumstances — they need to borrow a sobering \$111 billion this year. Anyone lending them this money might pause to reflect that their exposure to Portugal, the next wobbling domino, is almost \$80 billion. To pay off old debts, they need to find new creditors. From May until June, Portugal's government must borrow \$10 billion markets to survive. During those same months, Spain needs more than \$15 billion, even if it didn't run up a single euro in deficit over the year.

In this regard, 2011 looks horribly like 2008. Yet again, banks are treading water, hoping that they can continue to borrow — and trying to lay their hands on as much capital as possible to cover their losses. Yet their risk is the same as last time. We have seen how jittery world markets can become, and how calamitous the consequences can be. It only took one big bank collapse — Lehman Brothers — to scare the markets so much that they avoided lending to anybody. Then, it was banks that fell like dominoes. Next time, it might be governments. Barack Obama's 'stimulus' programme (named after its intentions, not its results) is predicated on his belief that America will be able to borrow as much as it likes because of the dollar's status as the world's reserve currency. Yet as the US continues its quantitative easing — that is, printing money — the dollar might cease to look like such a safe investment. Perceptions can change rapidly, especially for the United States, which has to renew around half of its almighty national debt every year. In the past six months, the US Treasury has had to increase the interest paid on its ten-year IOU notes to 3.5 per cent — a full percentage point higher than in the summer. If Uncle Sam's cost of borrowing keeps rising at this rate (Spain is shelling out 5.5 per cent, and Ireland 8.5 per cent), the US deficit will start to look like a black hole.

At this point, it is traditional to say: thank God for those roaring economics in East Asia, India and Brazil. But how real is their remarkable growth? Look closely, and even this may be in part a result of artificial stimulus. India's and Brazil's growth is financed by short-term capital from abroad: money that could disappear overnight. Easy money always ends up somewhere. The last time it was in property, this time it is in emerging markets (and often in the property markets of emerging markets).

China's wealth and prospects dazzle the debt-laden West. 'Money, money everywhere,' the Beijing economist Patrick Chovanec said in a recent survey of China. 'Awash in luxury cars, condos and expensive jewellery, the Chinese are enjoying what looks to be an unstoppable boom.' The prices of high-end properties in some of the wealthiest cities have almost doubled in two years. High street prices are also creeping up, prompting the government to tighten policy.

In fact, this is not the result of better prospects but of a monetary shock. Aside from the foreign capital inflows, China had its own stimulus package, as big as America's. Beijing has printed yuan and pushed banks and local governments to spend like drunken Keynesians. Absurdly, China's money supply is now larger than America's, even though its economy is a third of the size. We can see the results of this stimulus in stock market prices and in new roads, bridges and housing complexes all over the country.

Not that anyone wants to travel on those roads or live in those buildings. In August, China's largest energy company reported that an extraordinary 65.4 million residences have not consumed any electricity in the last six months — a fairly big clue that they lie empty. There are now entire ghost towns, like new Ordos in northern China, where tens of thousands of buildings erected from scratch stand empty. And yet property prices in Ordos have doubled over three years. It's not popular demand, it's pure speculation. In some quarters, China is being spoken of as the last, best hope for the world economy. But it might be the next bubble to pop.

In the original Superman film, the hero rescues Lois Lane as she falls from a skyscraper. 'Don't worry, ma'am, I got you,' he says, midair. 'You got me? Who's got you?' she replies. This is the question that no one is asking now. If China is lending to us, who is lending to China? If the governments are saving the banks, then who will save the governments? If the European Union is offering a safety net, who would be there to bail out the EU? There are other questions not being asked: which country, in recent economic history, has successfully borrowed its way out of a debt crisis? Why should it work now? And how can we justify saddling the next generation with such debt?

'The problem with socialism,' Lady Thatcher once said, 'is that eventually you run out of other people's money.' This time, it is worse: we are running out of our children's money, and our grandchildren's money. We are assuming we will have a never-ending supply of borrowed money, and we have no backup plan if this supply chokes up. Things may feel safe at the moment. We can still borrow easily from international markets. So could Lehman Brothers on 12 September 2008 — the day before the bank imploded.

I am an optimist by nature. Every generation tends to make terrible mistakes, and yet we have still managed to create the richest civilization ever — so the odds are that we'll work our way out of this financial crisis too. In the long run. But our reliance on debt can only make that long run even longer.