



The Fiscal Cliff—Lessons from the 1930s

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www.debtdeflation.com/blogs

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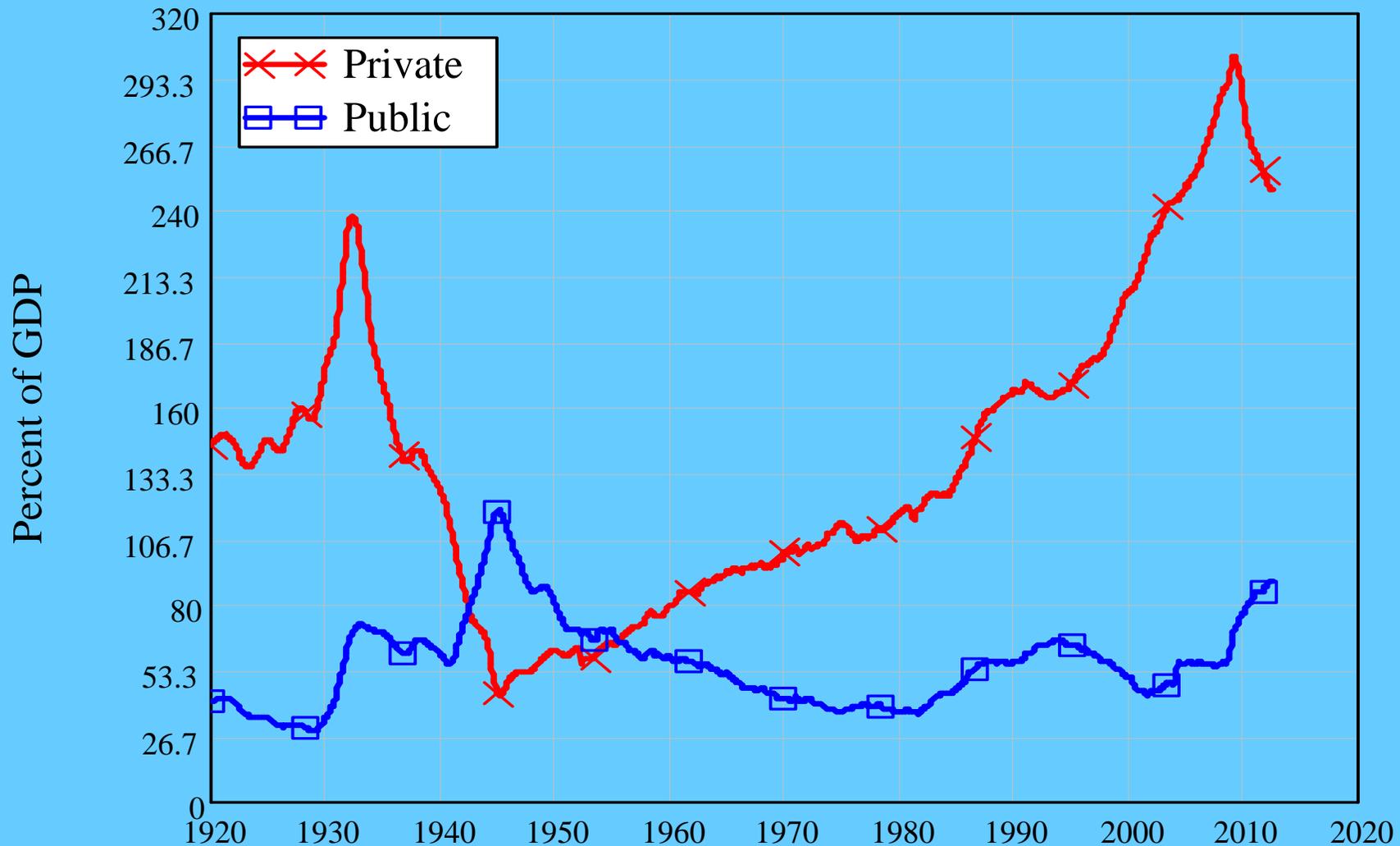
Key insights

- Understanding banks, debt & money key to understanding crisis
- Economists didn't see the crisis coming because they ignore banks:
 - “I'm all for including the banking sector in stories where it's relevant; but why is it so crucial to a story about debt and leverage?”
(Paul Krugman, “[Minsky & Methodology](#)”)
- Banks crucial because lending increases cash flow in the economy
 - Effective demand is income plus the change in debt
 - Analysis of dynamics of debt
 - Explains the crisis
 - Gives guidance to what the future may hold...

Key data: Debt to GDP ratios since 1920

- Why now is comparable to The Great Depression

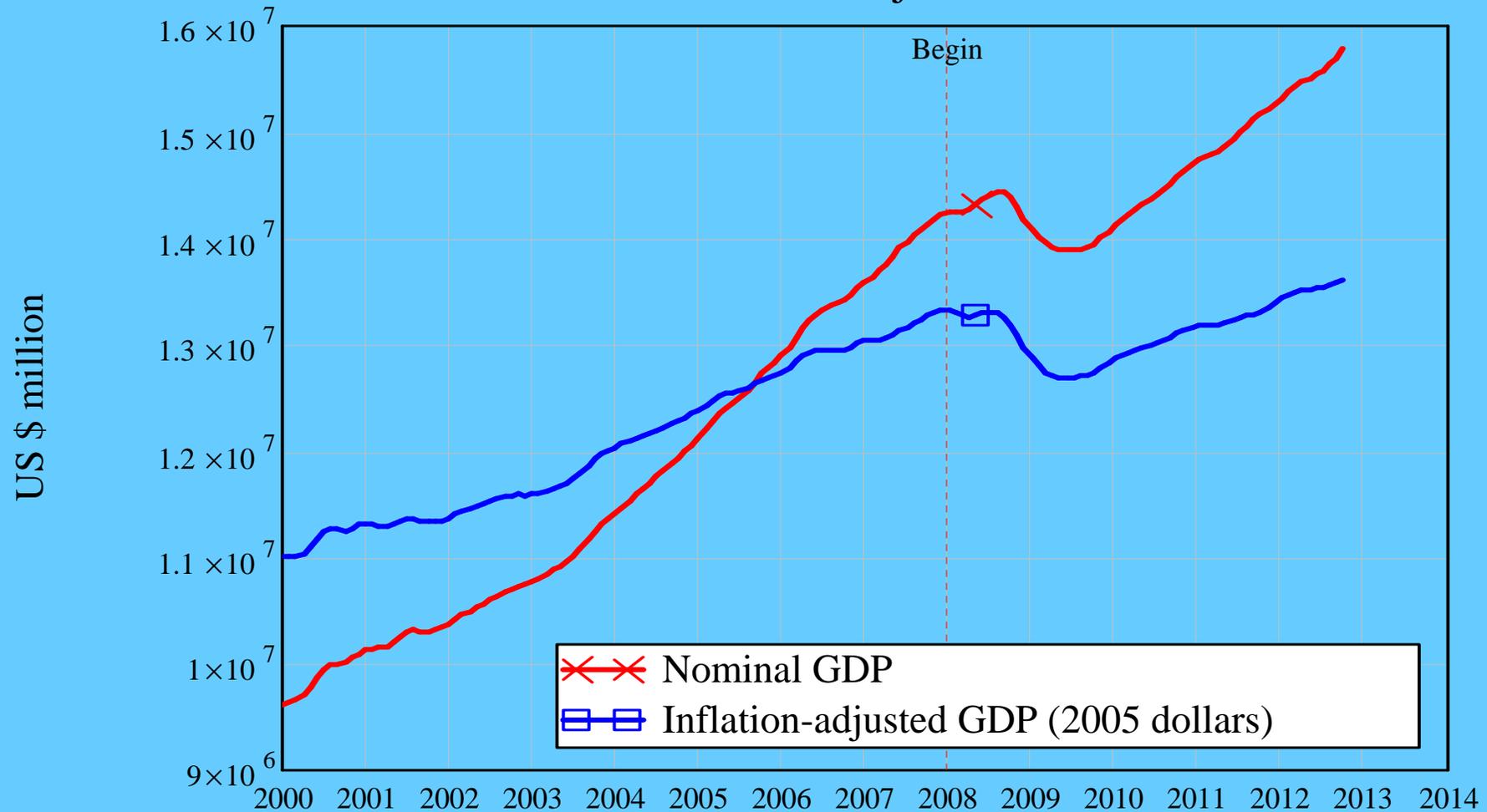
Long Term Debt to GDP



The economic crisis

- A fall in GDP, but nothing like the Great Depression...

Nominal and Inflation-adjusted GDP

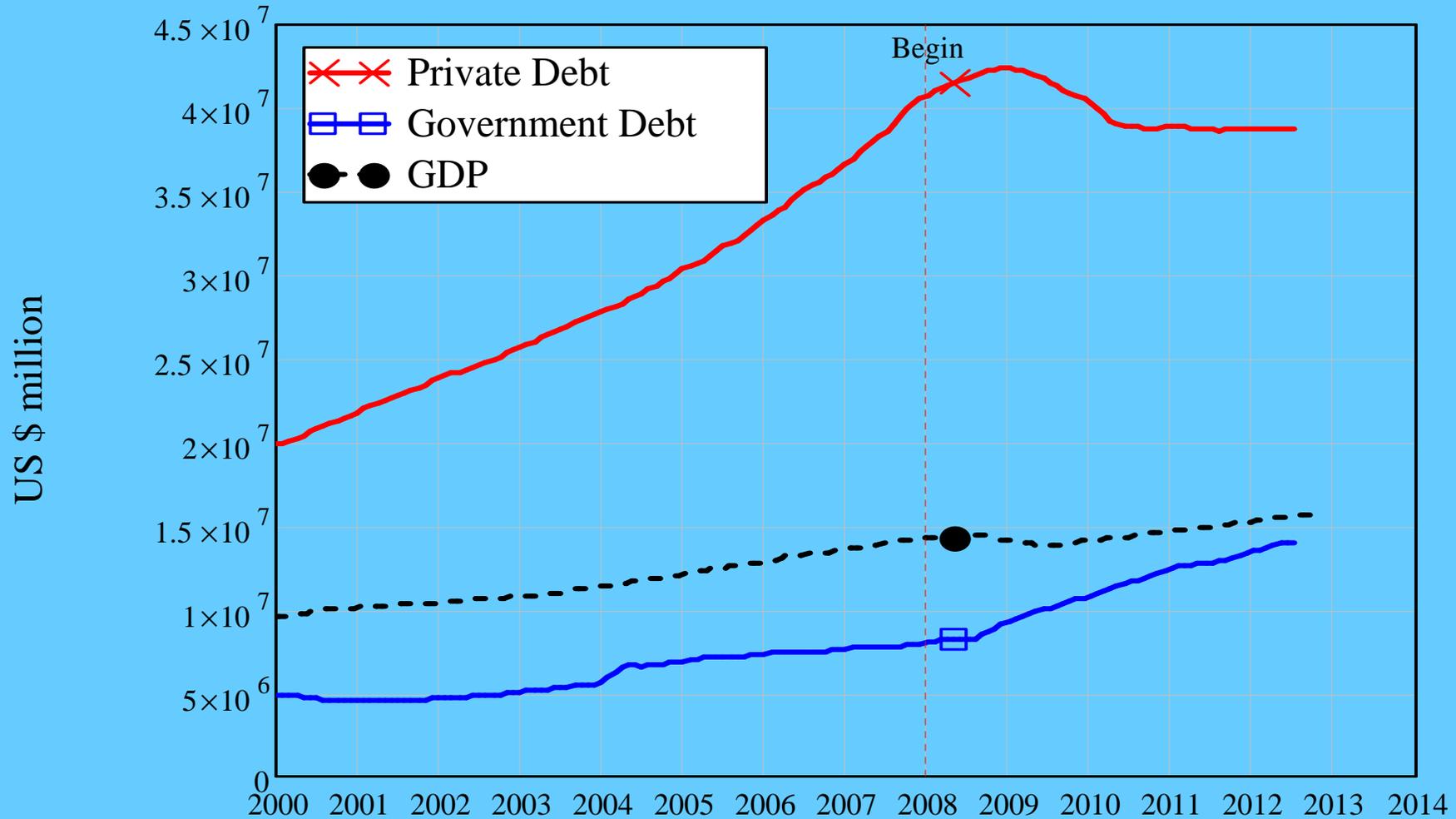


Source: BEA

GDP and the levels of private & public debt

- Private debt far bigger than both GDP and public debt...

USA Debt Levels and Nominal GDP

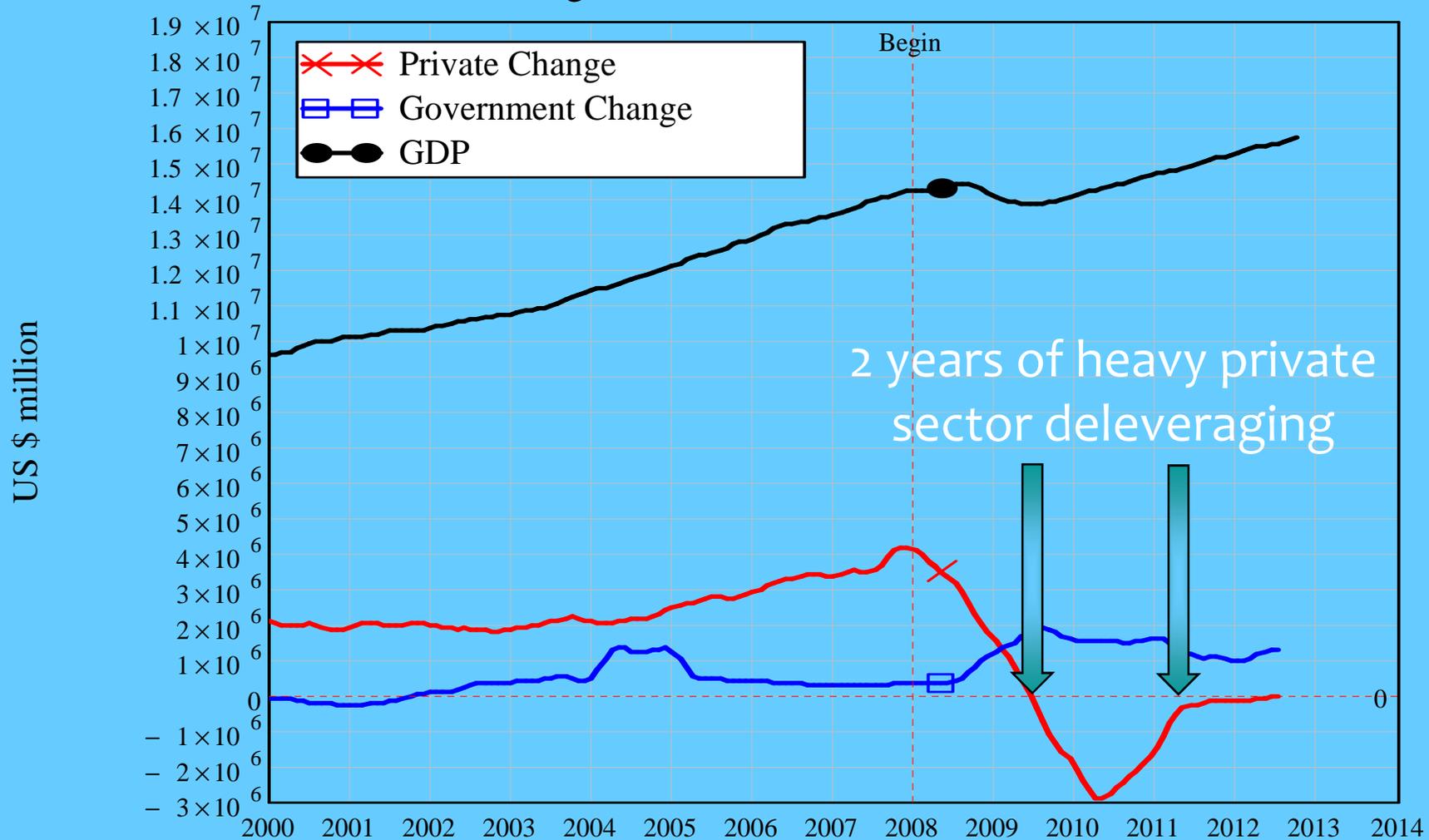


US Flow of Funds Table L 1

GDP and the change in private & public debt

- Crisis began when growth of private debt stopped...

Annual Change in Debt and Nominal GDP

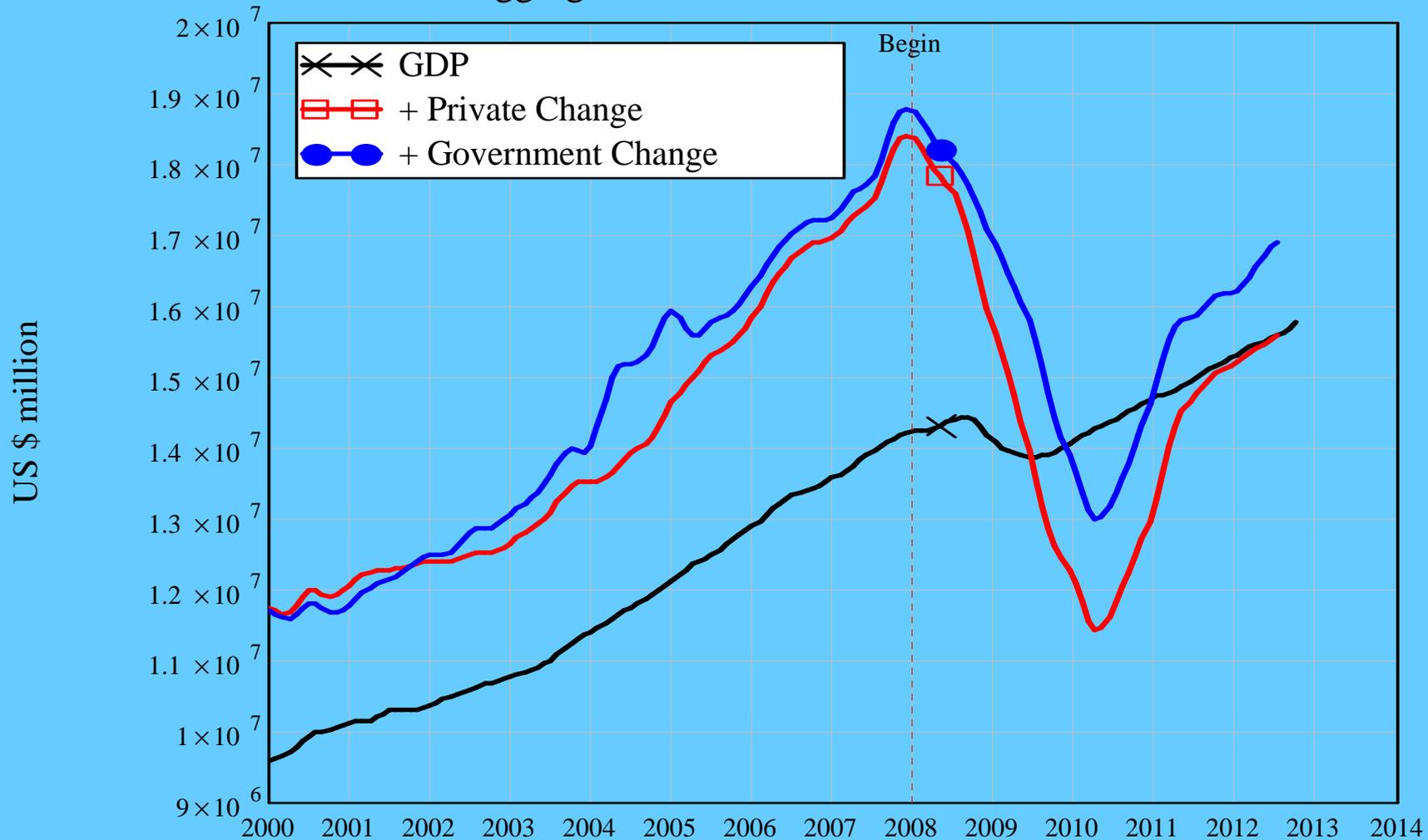


US Flow of Funds Table L 1

Effective demand as GDP plus change in debt

- Now the scale of the crisis is obvious...

Aggregate demand 2000 till Now

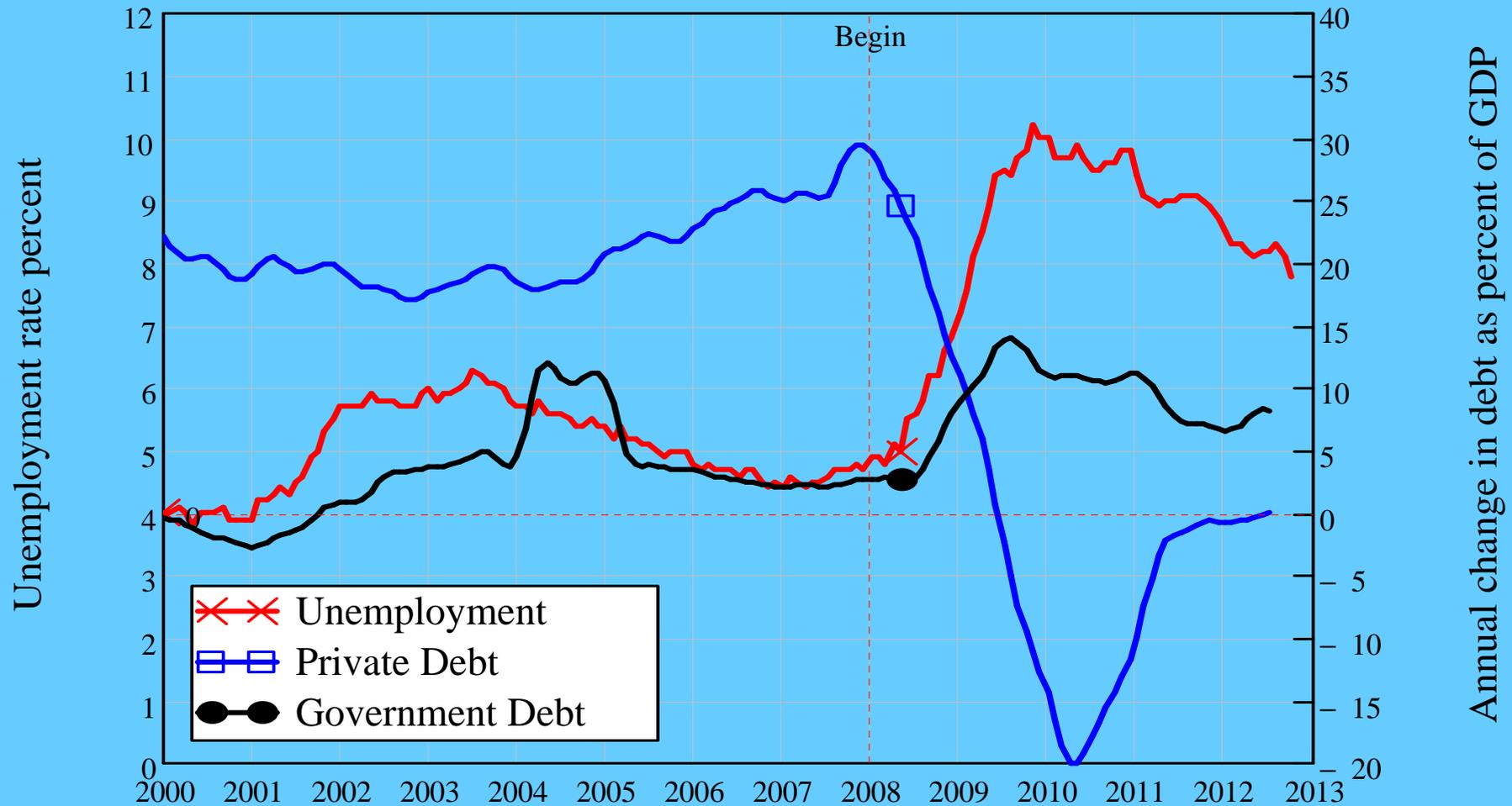


US Flow of Funds Table L 1

Change in debt and unemployment

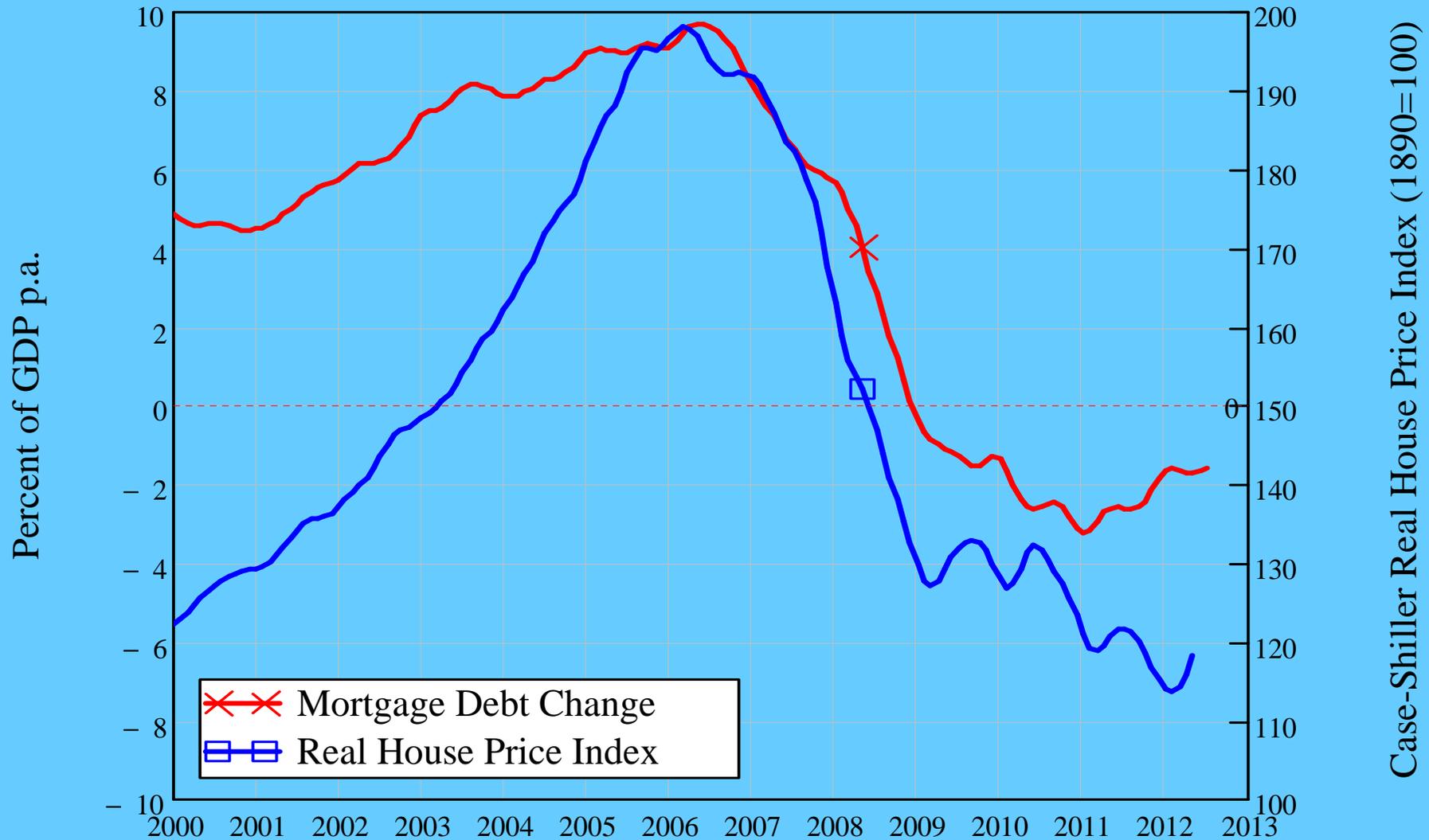
- Rising private debt causes falling unemployment;
- Rising unemployment causes rising public debt

Unemployment & Change in Debt



Debt and asset prices

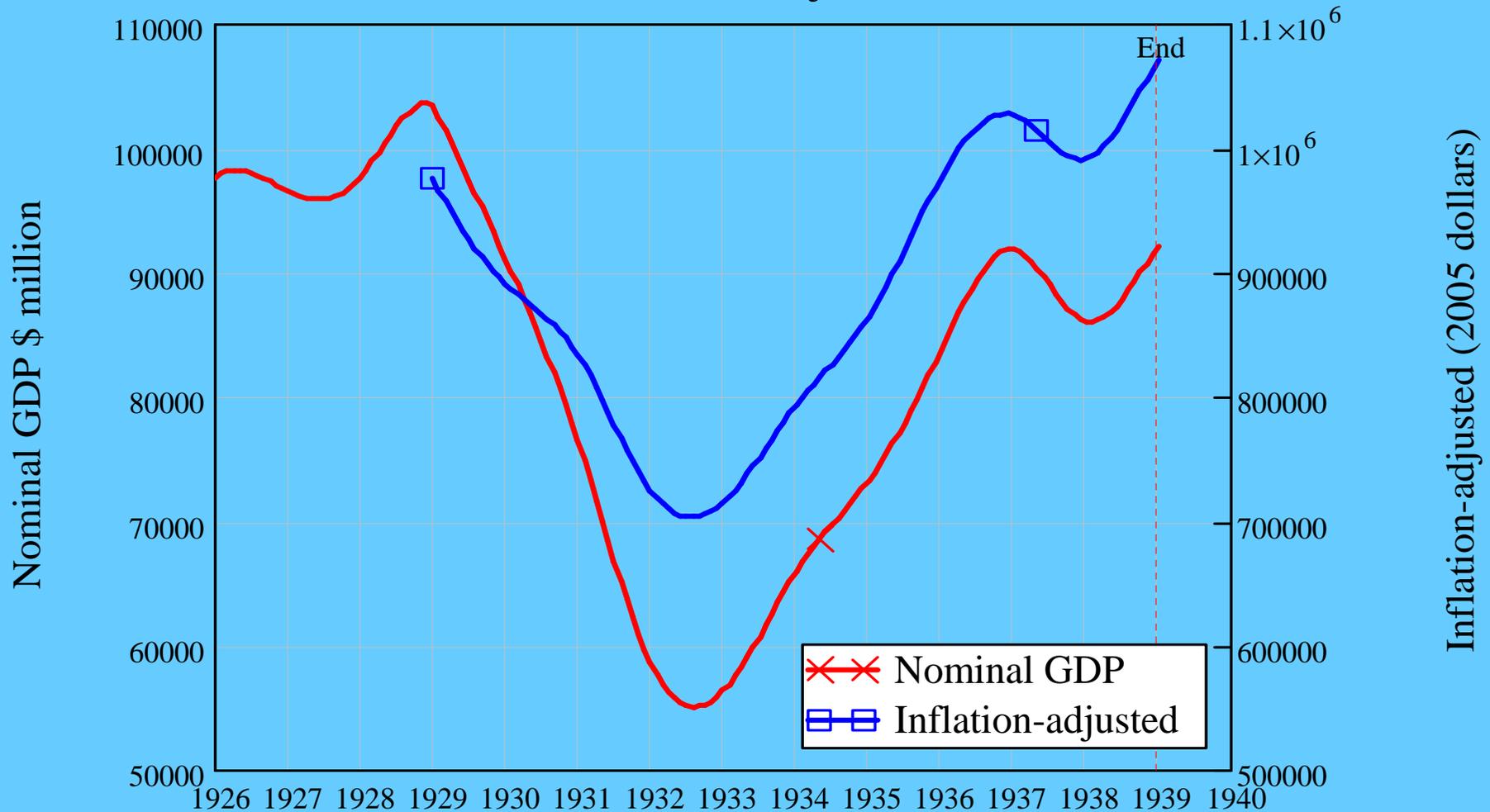
- Accelerating debt causes rising asset prices
House Prices & Change in Mortgage Debt



The 1930s collapse in GDP

- Much sharper falls in nominal and real GDP...

Nominal and Inflation-adjusted GDP

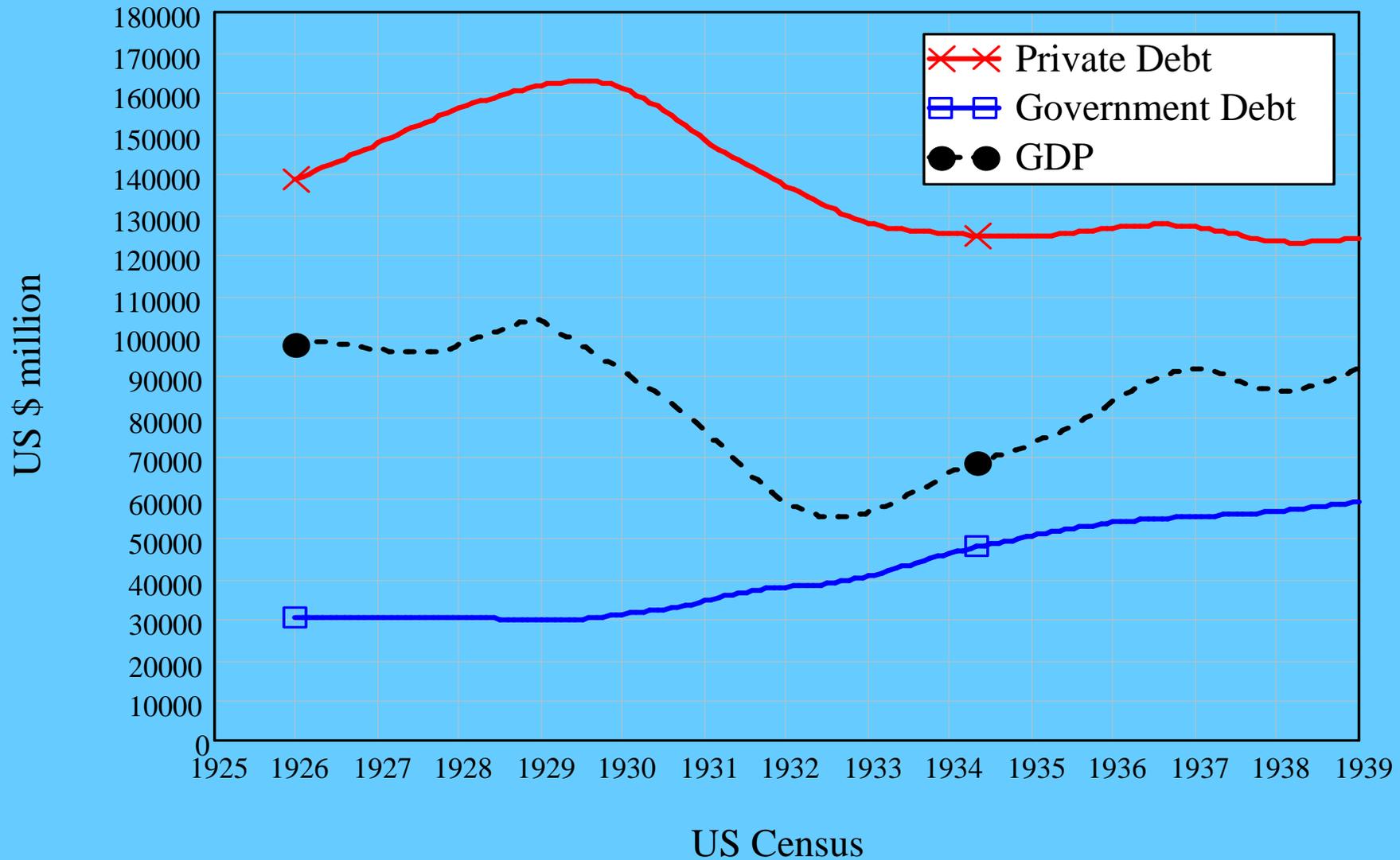


US Flow of Funds Table L 1

GDP and debt levels

- Much smaller debt bubble in the 1930s than today...

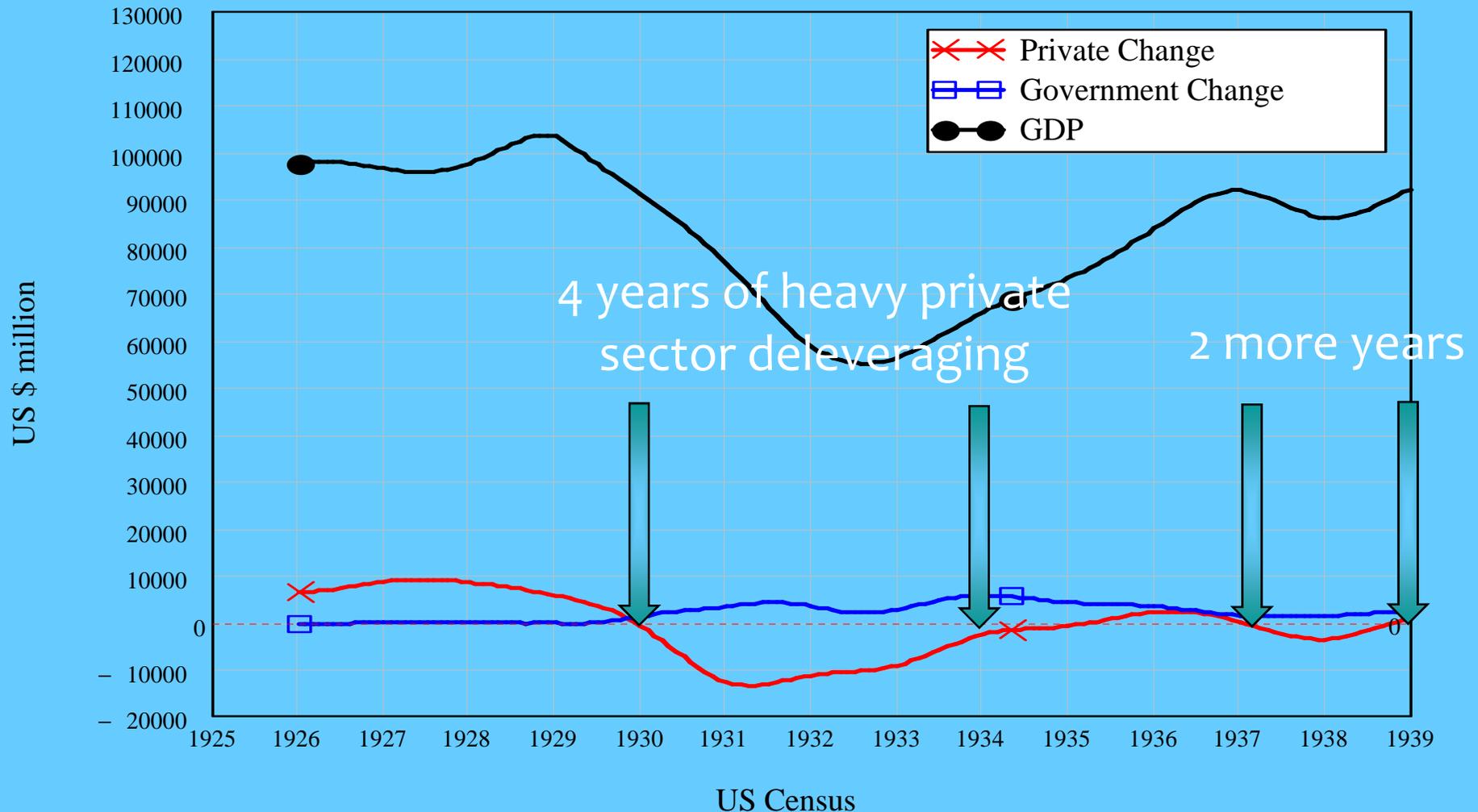
USA Debt Levels and Nominal GDP



GDP and change in debt

- Much longer period of private sector deleveraging
- Much slower and smaller government deficit response

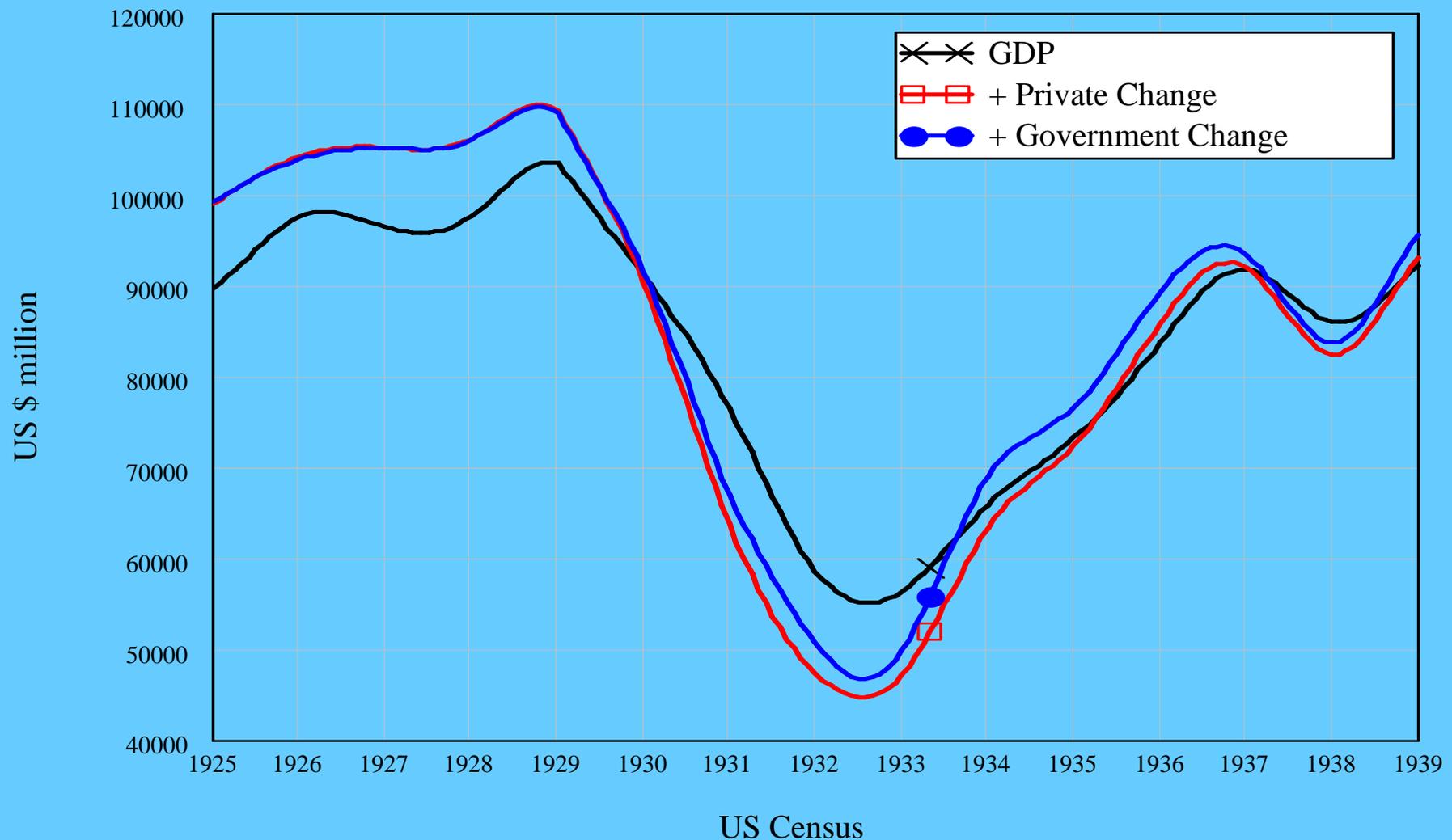
Annual Change in Debt and Nominal GDP



Effective demand: much longer plunge below income

- Extended deleveraging compared to today
- Relatively minor government stimulus response

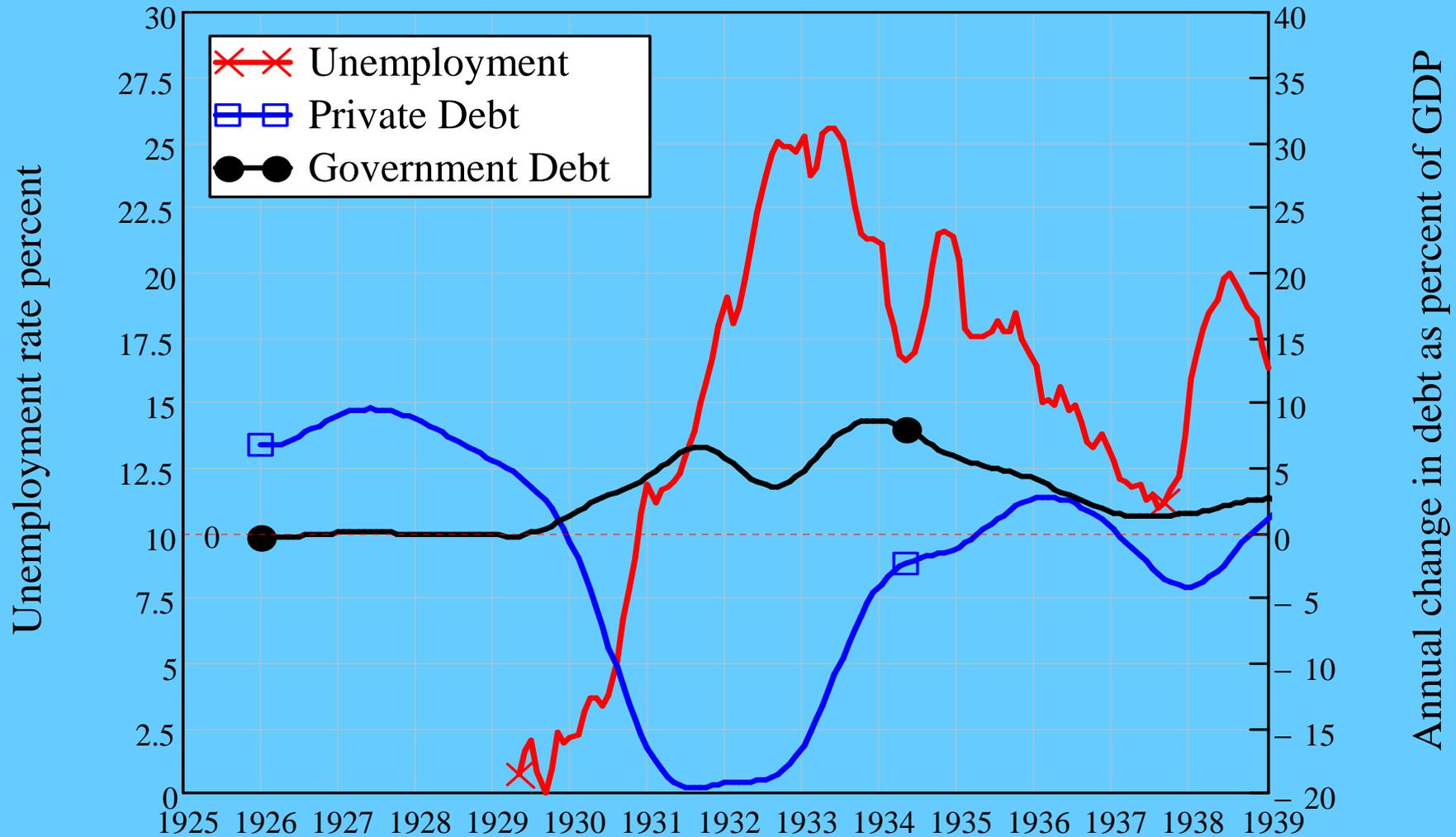
Aggregate Demand 1925 till 1939



The Fiscal Cliff of 1937

- Dip back into Depression as private sector deleveraging recommenced

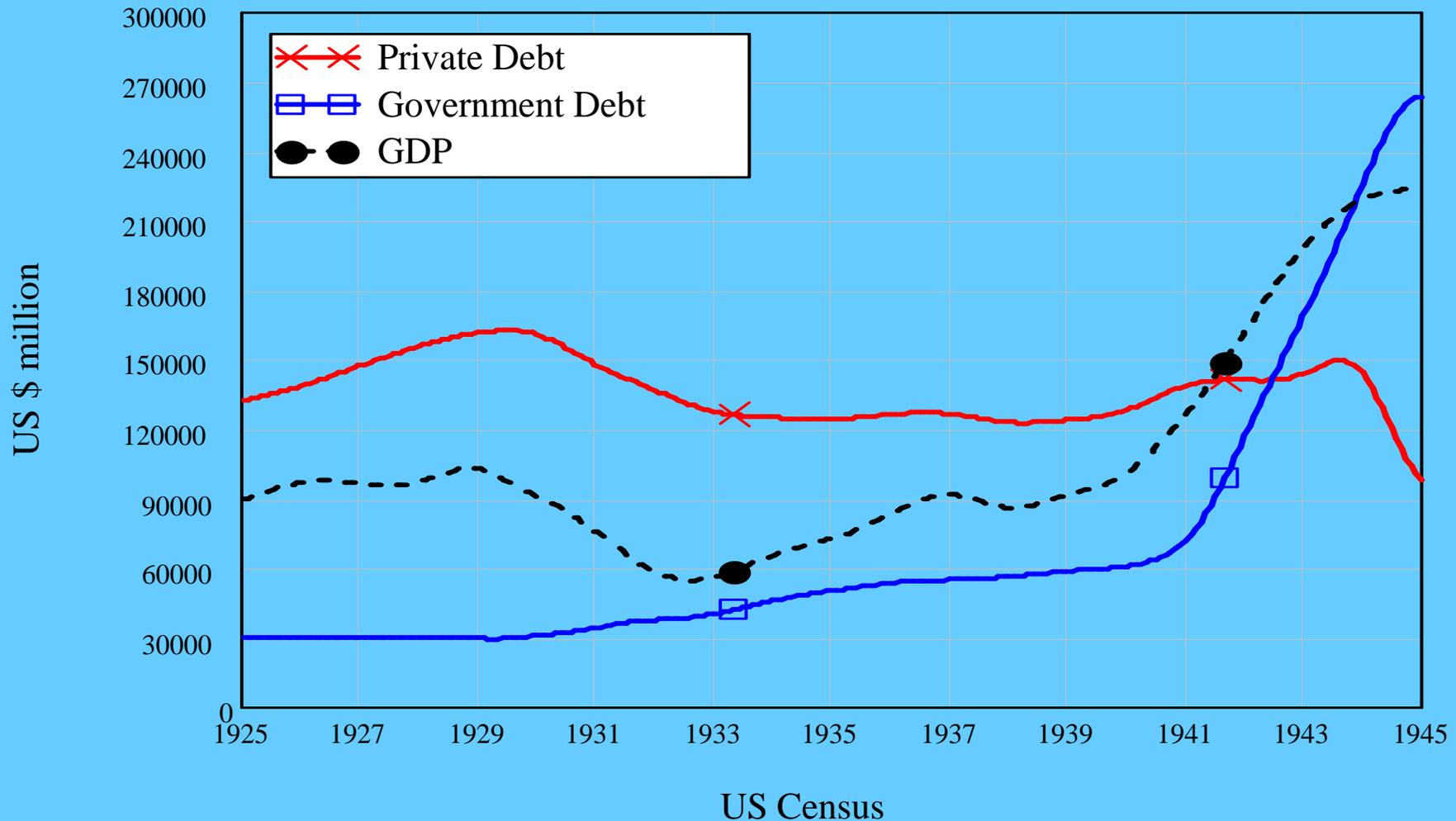
Unemployment & Change in Debt



Recovery in WWII

- Huge increase in government stimulus drives GDP up
- Private sector deleverages during WWII with minor impact on GDP

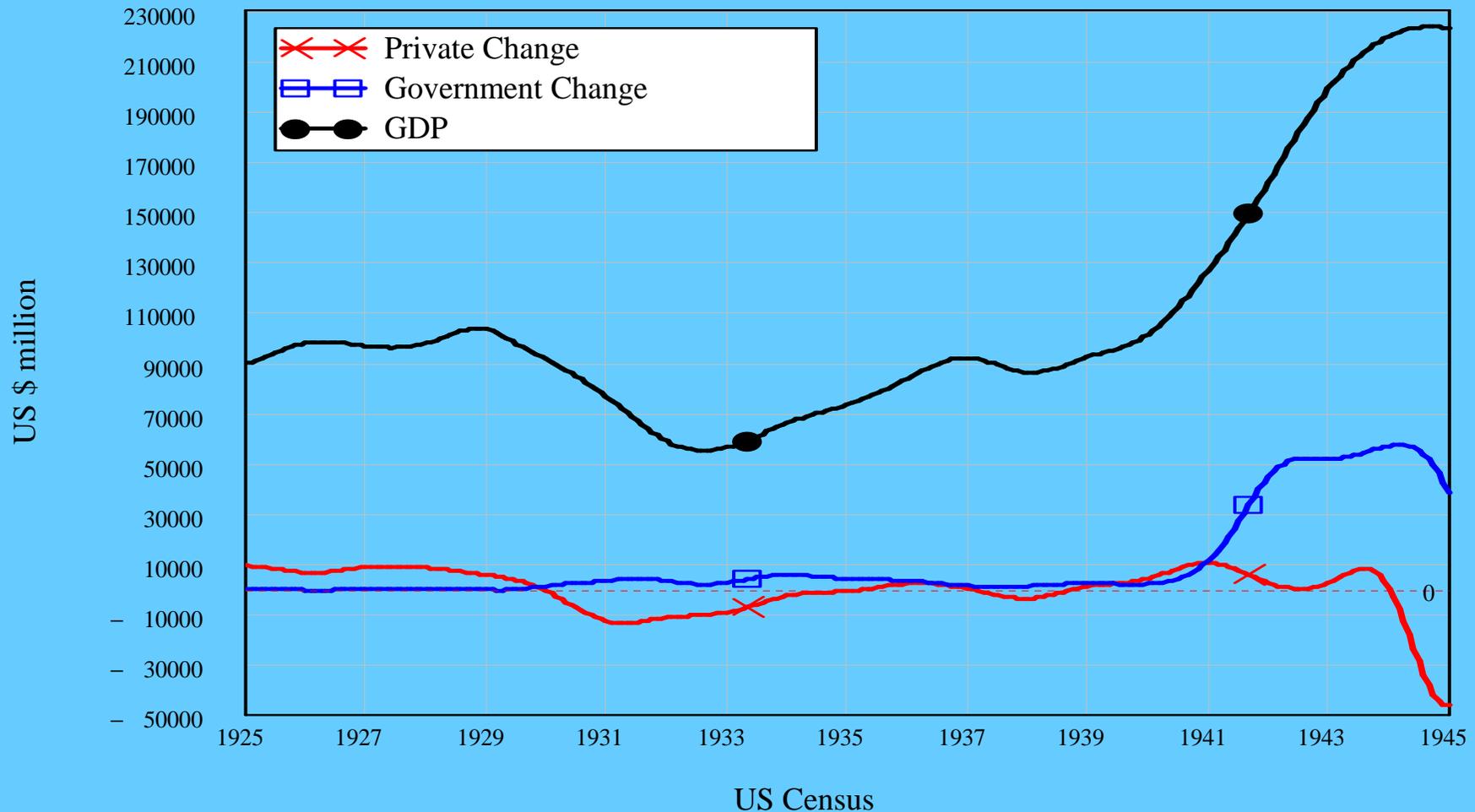
USA Debt Levels and Nominal GDP



Private sector deleveraging during WWII

- Fall in private sector debt far greater during WWII than during Great Depression, but little impact on GDP
- Stimulus, not austerity, ended Great Depression

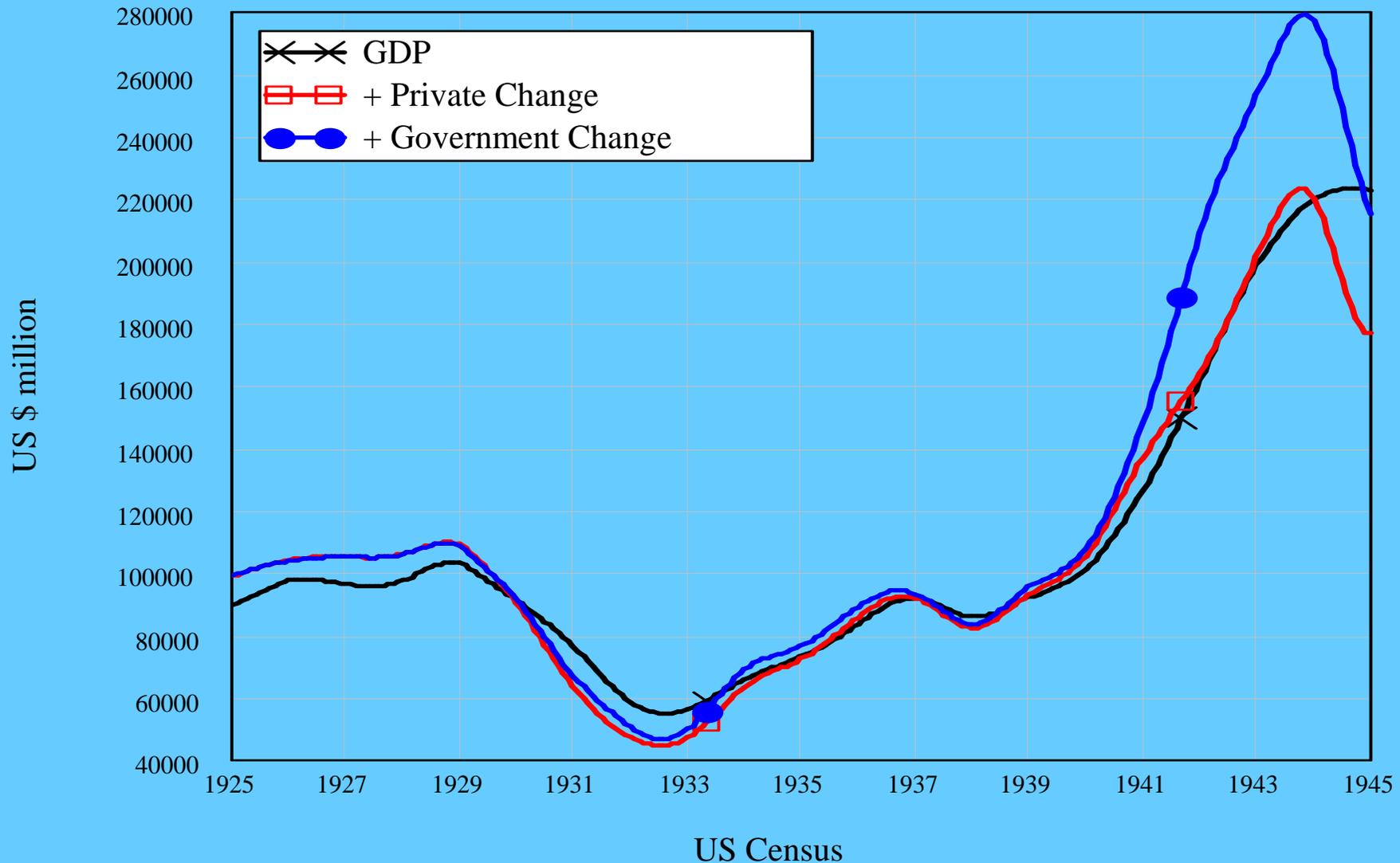
Annual Change in Debt and Nominal GDP



Private sector finishes deleveraging during WWII

- Private debt 45% of GDP in 1945—down from 175% in 1930

Annual Change in Debt and Nominal GDP



Takeaway Points

- Private debt and government debt are independent
 - But they affect each other
- Both boost demand in the economy when they rise
 - and reduce it when they fall.
- Private debt is more important than public debt because
 - it is so much larger, and
 - it drives the economy whereas government debt reacts to it
- The crisis was caused by the growth of private debt collapsing
- Government debt rose because the economy collapsed
 - and it reduced the severity of the crisis
- A premature attempt to reduce government debt through “The Fiscal Cliff” could trigger a renewed bout of deleveraging by the private sector, which could push the economy back into a recession.
- Main challenge of public policy is not reducing government debt
 - But managing the impact of the “Rock of Damocles” of private debt that hangs over the economy.