



THE JEROME LEVY FORECASTING CENTER

April 2012

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The Contained Depression: 2008–(2018?) *What It Is, Why It Happened, How It Will Play Out, and What Will Follow*

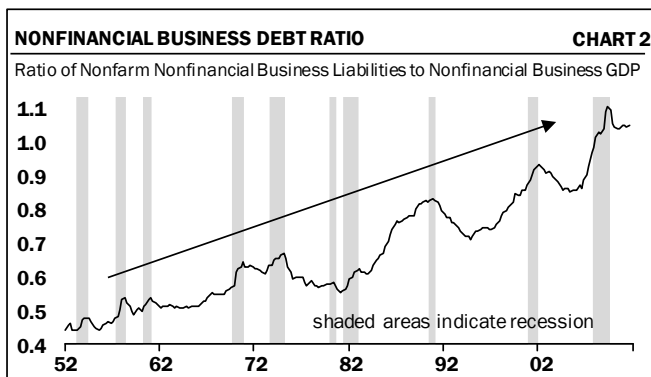
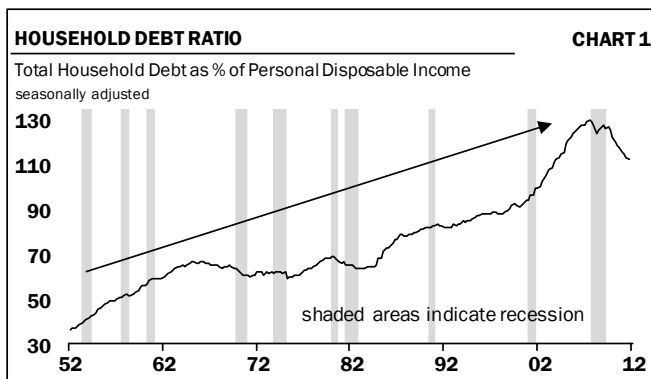
Most Americans hope that the economy will soon return to more normal conditions after having endured the 2008-2009 trauma and the ensuing slow, uneven recovery. Unfortunately, the economy's behavior is unlikely to seem normal for at least the next five years. There will be more deviations from the patterns of past decades and, in all probability, more jolting surprises. The oceans of government, academic, and private sector analysis of the country's recent economic challenges almost universally overlook some critically important factors, giving rise to both unwarranted complacency about some issues and unfounded fears about others.

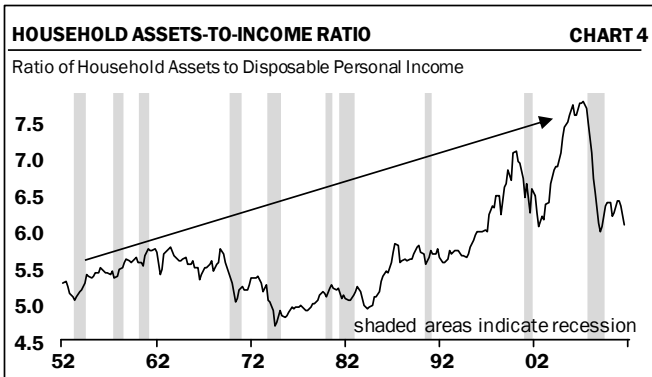
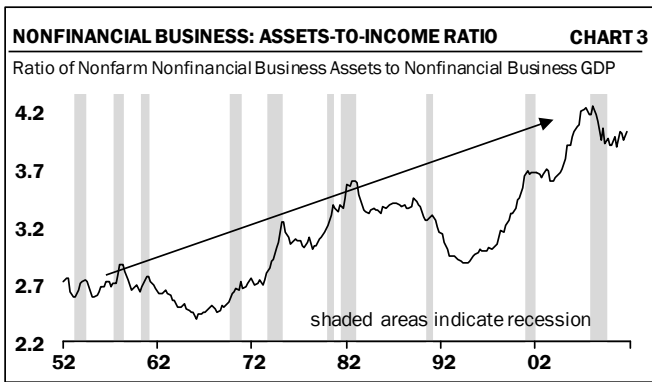
The economy is now undergoing adjustments in the private sector that have profound consequences for economic performance. Fortunately, this corrective process will eventually position the United States for a new age of booming investment and prosperity, but, unfortunately, the process will present hardships along the way.

To shed light on the possibilities for the next few years requires focusing on the fundamental forces at work in this unusual period in U.S. economic history, which requires first taking a few steps back in time.

In 2008, a phenomenon that had persisted ever since the end of World War II came to a halt. For more than sixty years, aggregate private sector balance sheets (both assets and liabilities) grew almost without interruption and, overall, faster than incomes (charts 1, 2, 3, 4). In the early postwar decades, this process reflected a necessary rebuilding of balance sheets follow-

ing fifteen years of depression and war. However, by the mid-1980s, balance sheets had become large enough to begin altering economic behavior in important ways; that is, the economy had become a *Big Balance Sheet Economy*. From that point on, asset creation, asset price increases, and debt expansion all accelerated dramatically, so already bloated private sector balance sheets became still larger relative to incomes. Debt ratios rose in all major sectors of the





private economy, overcapacity developed in many areas, and the prices of assets—corporate equities, residential real estate, commercial properties, patents, collectables, and so forth—rose faster than the incomes or value of services that the assets produced. However, balance sheets could not grow faster than incomes indefinitely, and, finally, the process broke down.

The economy is now well into a new era of debt reduction, weak net fixed investment, and asset deflation. This era will last at least several more years. It has been, and will continue to be, characterized by financially severe recessions, short and erratic recoveries, persistent debt performance problems, chronically high unemployment, and an abnormally large government influence on business conditions. These characteristics are all symptoms of an economy undergoing a multi-year, corrective process, the very process that has historically often spiraled into a disastrous economic collapse and deep depression. However, not this time. The government's large presence in the economy and its huge periodic interventions in financial markets will continue to prevent a crippling breakdown of the financial system and economy.

This new period is a depression, but fortunately it will remain a *contained* depression.

Eventually, after several more years of balance sheet correction (perhaps by the late 2010s), the combination of low levels of debt, an aged capital stock, the advance of technology, and newfound needs will create powerful forces for a new era of booming investment to replace much of the old capital stock. The process will create a vastly stronger economy, which will, among other things, greatly improve government finances and in all likelihood help shrink the public debt ratio rapidly. But until that happens, the economy's lagging performance and the government's huge deficits will undermine faith in the nation's future prospects.

What is a Contained Depression?

A depression can be defined as an extended period—five years, ten years, or longer—of weak economic performance and financial instability caused by *long-term imbalances* such as chronic overcapacity, severely overpriced assets, and grossly excessive debt levels. By contrast, a recession is a shorter period, usually a year or so, of contracting economic activity typically caused by *short-term imbalances* reflecting overproduction or temporary demand disruptions. The imbalances that cause a depression result from many years of overinvestment and other unsound behaviors, and resolving them takes years. The economy must reduce debt-to-income ratios, eliminate excess capacity, and bring the prices of assets back into line with their earning power—tasks made more difficult by paltry income growth, volatile but overall weak production, and periods of depressed earnings. A depression is not a continuous recession, and it may span multiple business cycles (the Great Depression encompassed two).

A critical aspect of a depression is the contraction in private sector balance sheets. The total value of privately held assets contracts, and the total face value of private debt contracts. While these adjustments may be necessary, they inherently cause business activity to plunge, further undermining debt performance and asset values in a vicious cycle.

A *contained depression* is a depression, but one in which the government contains the financial instability that comes with the depression and runs fiscal deficits large enough to limit declines in business activity.

The United States would have experienced a devastating economic collapse beginning in 2008 and would

have found itself in a full-fledged depression, but thankfully the modern U.S. economy has two critical containment mechanisms that were absent or severely limited in 1929. The first is the government's ability and inclination to serve as an effective *lender of last resort*, embodied in the Federal Reserve, the FDIC, the Treasury, and other federal government agencies. The government's ability to protect bank deposits, backstop financial institutions, and support financial markets has prevented widespread, 1930s-style bank failures and a seizing up of the entire financial system. The second containment mechanism is a federal government that is large relative to the size of the economy, making the government a much more potent fiscal stabilizer. (Federal outlays have averaged more than 20% of GDP in every decade since the 1970s, compared to less than 3% in 1929).

The government will almost surely succeed in containing the depression, but not because it will necessarily be especially wise about economic policy. Rather, it will have no choice but to keep patching holes in the financial sector, and its sheer size makes it a powerful fiscal flywheel. There will be rough periods for the economy, but no banking system collapse, no double-digit percentage point declines in GDP, and no rapid deflation. The government has virtually unlimited power to intervene to protect the basic functioning of the financial system, and in an emergency it can spend whatever is necessary. It can, as needed, take on far more debt than is widely believed and much more, in proportion to GDP, than most other countries can (see our report [Uncle Sam Won't Go Broke](#)). By the end of the contained depression, the U.S. government will have taken on many trillions of dollars in debt between financial system rescue operations and huge operating deficits. Although many will worry about the price tag, it will be a bargain for enabling us to avoid another Great Depression while positioning the economy once again for strong, healthy expansion. Government actions will not fix the fundamental problems that cause the depression, but they will greatly limit the financial and economic fallout as the economy fixes itself—as long as private balance sheet contraction is allowed to continue. Along the way, government can slow the correction process (as in Japan in the 1990s) or help it along.

The recession that began in December 2007 was only the first phase of the contained depression. The disappointing recovery since mid 2009 is the second

phase, and there will be more ups and downs before the contained depression is over. Over the next several years, private balance sheets will almost surely shrink much further. Although it is uncertain just how much or how fast they will shrink—or how much they may temporarily backtrack along the way—it is reasonable to expect that the process will take something on the order of a decade to complete.

Why Hitting the Limits of Balance Sheet Expansion Is So Serious

It is not hard to see that private sector balance sheets could not have expanded faster than incomes forever. Total private debt cannot rise relative to aggregate income forever because debts must be serviced out of incomes. Similarly, the total value of the economy's assets cannot rise faster than income forever because asset values must be justified by the income they generate. However, quantifying the limit to balance sheet expansion is difficult, in part because the limit can be extended by reducing interest rates and easing financial standards. Eventually, however, interest rates cannot fall further, and financial instability triggers fears that reverse the easing of standards.

It is a little less obvious, on the surface, why the contraction of private sector balance sheets is so calamitous. The reason is that private balance sheet expansion is directly tied to the processes through which an economy generates profits; if private balance sheets contract, profits dry up, and the private enterprise system breaks down. The full explanation of this process requires an understanding of the *sources* of aggregate profits (see our publication [Where Profits Come From](#)). However, the basic intuition is fairly simple: Profits are the wealth accumulated by the business sector during a period of time, and they are part of the total wealth generated by the economy. Total wealth cannot increase without aggregate balance sheets expanding, because new wealth shows up as new (or upwardly valued) assets on balance sheets, and liabilities rise as these asset gains are financed. When balance sheets actually contract, wealth disappears. The business sector experiences extreme difficulty accumulating wealth in an economy in which total wealth is shrinking.

In a contained depression, however, government loses wealth to the private sector (runs deficits) and especially to business. As a result, although house-

holds and financial institutions are losing wealth, business can still secure profits out of the wealth the government is pumping into the private sector in the form of its own liabilities. Depending on the magnitude of deficit spending, profits may remain paltry or surge to high levels, such as they attained in 2011.¹

How We Got into This Mess: The Growth of Balance Sheets during *Big Balance Sheet Economy* Era

Once an economy's balance sheets swell to the point where it becomes a *Big Balance Sheet Economy*, it is in increasing danger of heading into a depression—contained or not—sooner or later. Balance sheets cannot simply remain bloated; they must continue expanding rapidly or else profits will fall sharply, triggering a vicious cycle that causes balance sheets to contract. Eventually, as balance sheet expansion approaches its limit and slows markedly, profits weaken dramatically. Consequently, the business sector reduces production, fixed investment, and hiring, and the economy enters a recession. Both business and household cash flow worsen, so debt performance deteriorates and financial sector problems intensify. Meanwhile, asset prices are undermined by declining returns, deteriorating credit conditions, falling expectations for future returns, and increasing perceptions of uncertainty. These and numerous other effects form a vicious cycle of destabilization and decline, a great crash into a depression. That is, unless the containment mechanisms—the government acting as lender of last resort and fiscal stabilizer—take effect.

1. *In this explanation, changes in balance sheets and total wealth are defined to include changes in the market value of assets. In contrast, the national income and product accounts (NIPA)—the only available comprehensive data on the sources of aggregate U.S. profits—use a different accounting system in which changes in asset prices are not counted as changes in wealth. It remains equally true for both accounting frameworks, though, that “private balance sheet expansion is directly tied to the processes through which an economy generates profits,” as stated above. When using the NIPA data to analyze and forecast profits during periods of rapid asset price appreciation or depreciation, one must estimate the balance sheet influences on profits that show up only indirectly in the NIPA (such as wealth effects) or not at all (such as the financial sector’s trading gains during a stock market boom). For a fuller discussion of the sources of profits under different accounting systems, see Appendix 1 in [Where Profits Come From](#).*

From the mid-1980s until 2008, these containment mechanisms periodically came into play as balance sheets became larger and the economy's financial structure became more fragile. By 1990, balance sheet excesses had become large enough to have caused a vicious cycle that could have severely damaged the financial system and caused a depression. However, with (1) the federal deficit swelling to 5% of GDP, (2) the Fed setting monetary policy that enabled widespread debt refinancing and enabled banks to repair their balance sheets, and (3) the government protecting depositors while it stabilized and then cleaned up the savings and loan industry, the balance sheet problems were brought under control, effectively aborting a depression. The outcome was merely a recession and a prolonged, post-recession malaise.

In the early 2000s, balance sheet problems once again caused a recession followed by an extended malaise. The bursting of the stock market bubble in 2000 exposed overleveraged, insolvent corporations and led to a steep decline in capital investment. Households suffered sharp wealth losses, and household debt performance worsened more than at any other time in the postwar period to date. Yet, once again, government containment mechanisms prevented the economy from succumbing to a devastating, uncontrolled downward spiral of balance sheet contraction, financial crisis, and economic decline.

The early 1990s and early 2000s have much in common with the present era of contained depression but also a critical difference. All three episodes were triggered not by mere cyclical forces but by long-term balance sheet excesses. All three cases involved processes that would have caused deep, 1930s-like depressions had government not contained the damage. But in the early 1990s and early 2000s, efforts to stabilize the economy, which included dropping interest rates to well below previous modern lows, launched new episodes of even greater balance sheet expansion. By contrast, in 2008 the Fed ran out of room to lower interest rates enough to prevent severe debt performance problems. And, whereas in the early 1990s and early 2000s private sector debt did not contract, in the present episode private sector debt has contracted substantially (chart 5). Private sector debt relative to GDP is now undergoing its first substantial decline in several decades (chart 6).

(We coined the term “contained depression” in July 1990 to describe our economic outlook for the coming years, but the concept has evolved considerably since then with the benefit of two decades of analysis and observation. The periods 1990-1993 and 2000-2003 are now more properly called “aborted depressions” because containment efforts not only stabilized the economy but set in motion the next round of rapid balance sheet expansion. Depression was not merely moderated, but postponed, and balance sheets—and the stakes—kept getting bigger.)

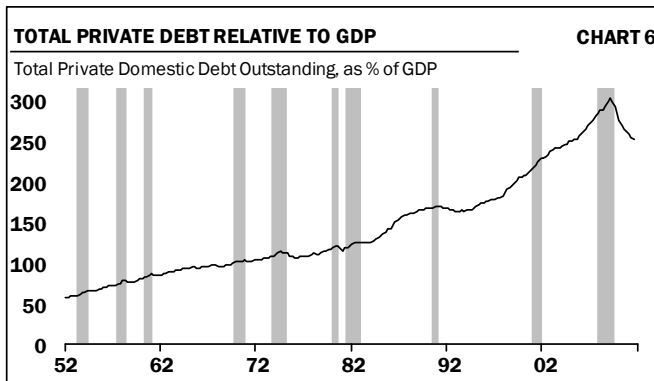
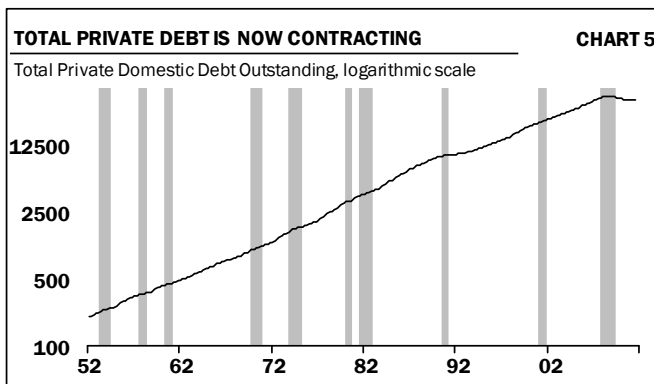
Implications of the Contained Depression

The contained depression has important implications for investing and managing businesses both for the next several years and for the long run. From a practical standpoint, the contained depression can be summed up as an unfamiliar, dominating set of influences on the economy lasting for a decade or so, after which time markedly different economic influences will surface.

A wide variety of economic parameters and variables are behaving differently than in the past because of the contained depression. They include inflation, Fed policy, the shape of the yield curve, the dollar, asset prices, the potential for another major macroeconomic bubble, financial market volatility, the relative performance of certain business subsectors, and relationships between security prices and various commonly-watched financial metrics. The contained depression has implications even for market-neutral trading strategies and noncyclical businesses.

Although many acknowledge the “headwinds” from deleveraging in the next few years, few recognize how deleveraging interacts with the generation of business profits and financial conditions. Conventional macroeconomic models will remain at risk of proving ineffective—or worse.

Of course, the contained depression is hardly the only important influence or story in the U.S. economy. There are also cyclical dynamics and long-term, secular trends having nothing to do with aggregate balance sheets but rather with technological change, global economic evolution, shifting demographics, environmental challenges, and other phenomena. Neverthe-



less, projecting cyclical and secular trends *without* taking the contained depression into account may be hazardous.

And, of course, there is the international dimension. While beyond the scope of the present discussion, there are and have been similar excesses in private balance sheets elsewhere in the world. For example, Europe’s imbalances are greater than the United States’, and the containment of its depression is more problematic. Whereas the December 2007 U.S. economic downturn (the start of the contained depression) was caused by domestic balance sheet problems, the next U.S. recession within this period of contained depression is likely to be triggered and accentuated largely by developments overseas.

The U.S. economy has been making progress reducing its private balance sheet excesses, but much more work needs to be done. It is getting healthier from a long-term perspective, but it remains troubled and in a troubled world. The transformation will create great opportunities, but also many dangerous traps. Long-term healing should not be confused with returning to more normal conditions in the next few years.

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