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Debt-based Historical View vs. Productivity-based Historical View (Part 1)

It's time to liquidate 'liquidationism'

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The process that has taken us from the Lehman shock to the European currency crisis clearly shows that we now stand at an historic turning point. We are witnessing events that cannot be explained or resolved by using solely the past beliefs about economic cycles. The result is the immediate and rapid spread of the pessimistic view that 'another Great Depression is coming and the beginning of a dark age is unavoidable.' However, history did not end with the Great Depression. A prolonged period of prosperity followed this economic downturn. Furthermore, studies by economists have led to the conclusion that 'the Great Depression was not inevitable (and thus could have been avoided).' If this is true, a financial crisis should hold the potential of leading to the next phase of prosperity. But we need to carefully verify how this process functions. This is why analysts should not waste their time embracing the fatalistic stance that the outlook is bleak.

One fault in current thinking is that people are fixated on a debt-based historical view that lacks balance. What is strange is that the Bible for these pessimists is the book This Time is Different by Carmen Reinhart and Kenneth Rogoff. It is just as strange that the belief that government deficits are the single greatest economic problem in Japan, a view led by the Ministry of Finance, has become the gospel of economists, opinion leaders and the media.

At times, we must look at history from the perspective of debt. But looking only at debt is an unfair viewpoint that does not yield a correct understanding of the current situation. Productivity is a much more important perspective for a historical view. Advances in productivity backed by technological progress have been responsible for improving the standard of living of mankind. Debt (credit) is nothing more than something that accompanies this improvement. In this report and in the series of reports that will follow this one I will examine the past, present and outlook for future by using a combination of the debt-based and productivity-based historical view.

(1) It's time to liquidate 'liquidationism'
(2) The history of the DJIA over the past 100 years is linked to productivity and credit
(3) What is the significance of the upturn in the price of gold during shifts in the currency system?
(4) Is a sustained recovery possible in the U.S. economy, with its high earnings, unemployment and savings and low spending?
(5) Let's end the crisis that has been resurrected by debt hysteria
(6) Japan has been presented with an historic opportunity
(7) One scenario: How can we eliminate the gap between profit margins and interest rates?

(1) It's time to liquidate 'liquidationism'

The capitulation of optimism and the capitulation of government policies

Global stock markets appear to be in the midst of a plunge that is similar to the downturn sparked by the Lehman shock. At a time like this, investors must understand that the pattern for stock prices to hit bottom is completely different from when market conditions are normal. During an ordinary economic cycle, stock prices stop falling and start rebounding when optimists have sold out. But during downturn fueled by panic, stock prices keep falling even after optimists give up. Stopping the downturn requires a switch in government policies (the capitulation of politicians who were clinging to mistaken policies). After the 2008 Lehman shock, the crisis was turned around by the decision to enact the Troubled Asset Relief Program (TARP) to save banks even as banks were the target of much criticism. In Japan as well, the government rescued (did not fully nationalize) Resona Bank, which was the target of criticism by the media and others, by injecting public funds. Taking this action ended the prolonged downturn in stock prices. (But the rebound was interrupted by the reemergence of the 'liquidationism' after the Livedoor incident, which signified the return of punishment for risk-taking). Even during the Great Depression, stock prices stopped falling in 1933 when President Roosevelt announced initiatives for economic growth. This followed the end the Hoover administration, which had been concentrating instead on dealing with problems from the past. When another recession started in 1937 as the economy was recovering from the Great Depression, the end to the downturn followed the same pattern.

'Liquidationism' transformed a simple recession into a panic

Exactly what are the mistaken government policies that must be corrected to end a stock market downturn? The answer is 'liquidationism'. That means liquidating a swollen economy created by past inflation and debt with no fears about causing bankruptcies and unemployment. The goal is returning to the proper balance. This is what must be done.

First, pay off past debts. 'Liquidationism' requires the understanding that is impossible to mark a new start without doing this. This is an argument that is accepted by a public that is obsessed with journalism and the greedy criticism during the asset bubble era. However, this is an extremely harmful mindset because it results in failed policies that concern problems of the past rather than the future. One courageous position is to 'repay loans first, liquidate unprofitable companies, correct excessive spending and punish reckless risk taking.' But before this can happen, there can only be a collapse caused by 'a negative cycle in which fear creates more fear.' The reason is the 'liquidationism' is more a type of jealousy wearing a mask of justice than an economic theory. This is because checks are ineffective. If this were an economic theory, its efficiency would allow confirming that theories and policies are effective and correct. But since verifications are impossible for beliefs and thoughts, it is extremely difficult to make corrections.

Many government policies are influenced by 'liquidationism' and go beyond the bounds of rational economics. Examples include Germany's criticism of the Greek government's debt, criticism of sovereign debt in general, problems involving banks' balance sheets, and criticism of debt by the Tea Party in the United States. These policies are most likely the cause of volatility in financial markets. In Europe, we may see a default by Greece, a Greek withdrawal from the euro and the demise of the euro . These events would instantly liquidate past borrower-lender relationships and terminate all economic activity based on credit.

Pessimists believe that the current problem has emerged because the Lehman crisis was not resolved but only pushed back to the following years. However, this is a one-sided view. The history of mankind is not fixed or fatalistic. Progress was realized through correct selections by people from among a broad range of options. During the Great Depression, the United States lost half its industrial output and one-fourth of its jobs. But this was not inevitable. Choosing the erroneous policy of 'liquidationism' was what triggered the depression. As a result, the economy recovered when these policies were corrected. Consequently, the Great Depression could have been avoided if the right policies had been implemented.

Keynes stated that 'practical men are usually the slaves of some defunct economist.' Therefore, politicians and bureaucrats make mistakes because they are using the mistaken thinking that resulted in old mistakes of the past. Keynes also said that 'it is ideas, not vested interests, which are dangerous for good or evil.'

Stock prices may keep falling until 'liquidationism' has run its course. If this happens, we may see an excessive drop in prices (a negative bubble) just as we did immediately after the Lehman shock. In this case, the next step will be a V-shaped stock market recovery.