ECONOMIES BENT OUT SHAPE

Here is a vivid picture of the US economy. It is a body obese with fictitious capital, whose arteries are clogged by debt, limbs that are ulcerated by deindustrialisation, outside fists from arms spending but with a still functioning brain. This article looks specifically at how the growth of fictitious capital has bent the US economy out of shape. Other countries too. Only the US is the most advanced.

The understanding of how this has come about begins with an understanding of the supply of money that has underwritten speculative excesses. Excesses that far exceeds any seen before in the history of capitalism, at least outside China.

According to the Bank of England (BOE), 79% of money is bank money created by banks in the form of electronic money consisting of deposits, 3% consists of notes and coins leaving a balance of 18% as reserves at the Bank of England. https://www.bankofengland.co.uk/knowledgebank/how-is-money-created Let us deal with the 18% of reserves held at the BOE. This is not insurance for a rainy day, nor it is it compulsory reserves demanded by the BOE to restrain lending. Instead these reserves are the amount needed by banks to pay each other as their depositors transfer funds between banks. Let us say BP the largest UK company has to pay HMRC a £1 billion tax bill. It draws these funds held in an account at the Royal Bank of Scotland which then transfers this £1 billion to an HMRC bank account held at Lloyds bank. The Royal Bank of Scotland needs to ensure it has more than 1 Billion Pounds in reserve with the BOE to meet this obligation. So reserves are really each bank's current account held at the BOE with which they pay each once their obligations have been netted out.

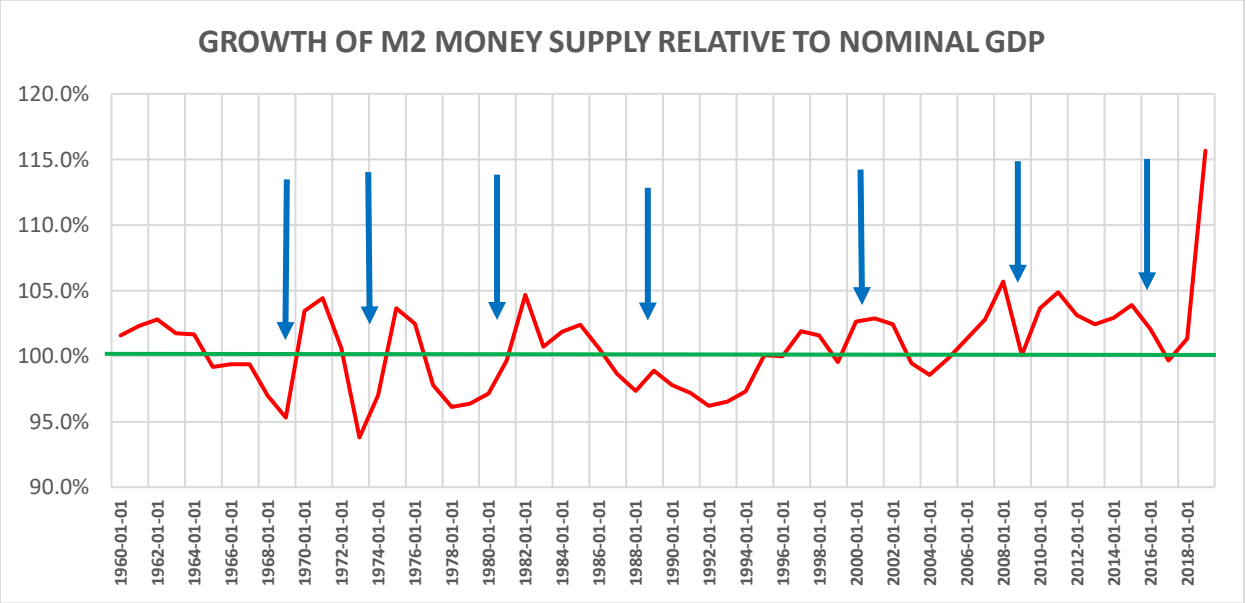
With that out of the way we can turn to the biggest element of money – electronic deposits. "*So essentially, banks create money, not wealth. Banks create around 80% of money in the economy as electronic deposits in this way."* So says the BOE. One wonders how much they pay their economists because this statement is nonsense. It is important to note there are two types of deposits. The first flows from the role of banks as an intermediatory not only between lenders and borrowers, but also at an individual level as the custodian of funds prior to their withdrawal. In this case we are talking about the depositing of revenues, be they wages, rents, interest, profits or tax. For example when your wage or pension is paid to you, it invariably is deposited directly into your bank account, and over the course of a month or so you gradually withdraw it to pay your bills etc.

The point about the deposit of revenues is that this is the depositing of value. It is not a debt which is owed to anyone. Its primary purpose is money as means of circulation and it is as permanent as the owner of those funds chooses to make them. It forms the bulk of deposits and has nothing to do with money creation by the banks as its source lies outside the banking system.

The smaller part of deposits are the deposits that banks create when they make a loan. This money does not belong to the borrower but the bank and is lent to the borrower under specific conditions, primarily the rate and term. This money is impermanent. It lasts only for as long as its' term. Hence the best name for this money is "credit money" as it is only temporary money. This credit money is not to be confused with the money held in ordinary deposits which belong the holder of the account rather than the bank.

Now it is true, that by making loans deposits increase which swells the money supply. But the money supply can swell even if no loans are made. This will always happen when nominal GDP increases. Everything else being equal, especially the velocity of monetary circulation, a rise in GDP will be associated with a rise in revenues. When deposited these will swell deposits leading to the rise in the money supply or M2 as it is called. Thus if we want to see what element of deposits is due to revenue and what element is due to new loans (credit money) the growth in nominal M2 must be deducted from the growth in nominal GDP. This is done in Graph 1 which looks at banking in the USA.

Graph 1.



(Source FRED Table M2SL for money supply and FRED Table NGDPPOT for GDP.

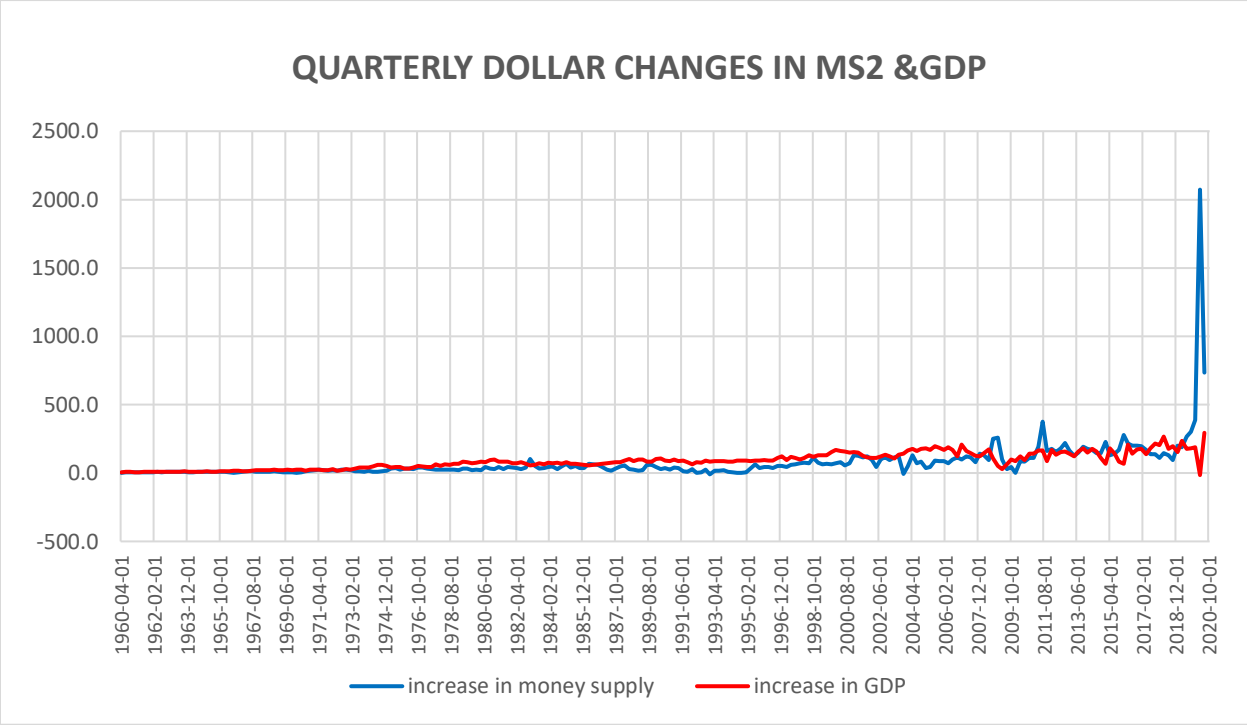
This graph contrasts the percentage changes in nominal M2 with nominal GDP. We note that the relative range is about 95% to 105%. So actual credit money creation and destruction actually takes place in a tight range. The other useful aspect of this graph is that it highlights the business (industrial) cycle. The blue arrows record the periods of recession and stagnation when the growth of the money supply contracts relative to GDP. Fewer loans are made and more are repaid, often involuntary as banks demand repayment. Also of note are the dips in 2016 and 2019 when the economy slowed down.

On the right-hand side of the graph, we find an unusual spike. That is the pandemic spike caused by Relief funds paid out by Congress finding their way into and out of the banking system. This can be seen in Graph 2 below. It shows the influence of the $2.2 trillion CARES Act signed into law on the 27th March 2020. This graph has the added advantage in showing the quarterly changes in Dollar values between GDP and M2. On average, and latterly prior to 2020, the quarterly variation amounted to around $100 billion.

Thus net credit money is far less significant than many internet professors make out. Sure banks can create this kind of money with a fountain pen or the entry key on a computer, but the fountain pen is certainly smaller than most people think. It only appears big when credit money is confused with money itself. It certainly is much smaller than the trade credit issued by producers and merchants to circulate commodities in production, wholesale and retail which is why Marx focused on this form of credit in Volume 3 of Das Kapital. For example, stripping out the retail sector where cash is found, the increase in

circulating capital was $291.28 billion in 2013, $319.02 billion (2014), $386 billion (2015), $303.16 billion (2016), $422.14 billion (2017), $557.46 billion (2018) $384.11 billion (2019). If only 60% of that is financed through trade credit it exceeds the increase in credit money itself.

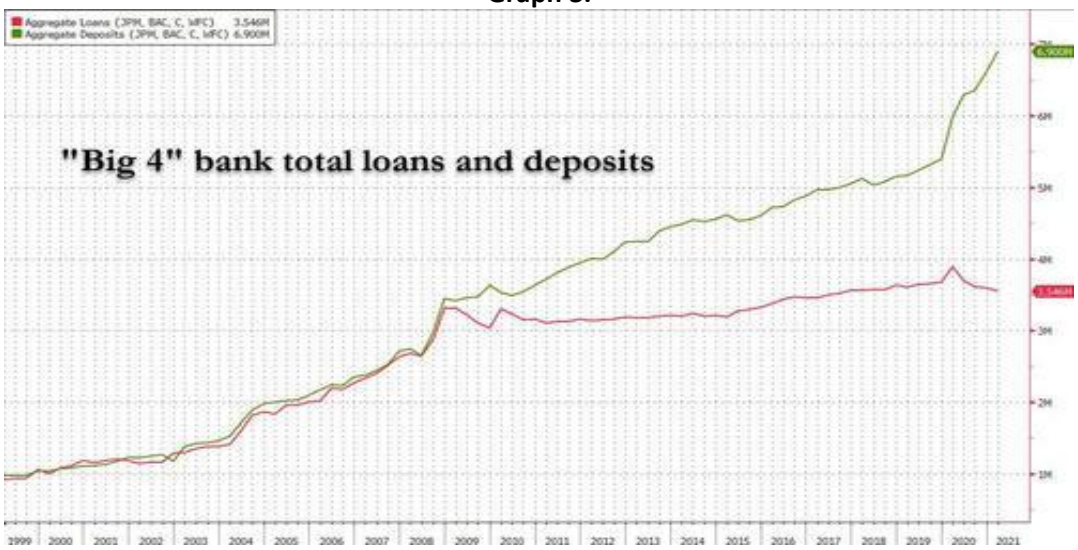
Graph 2.



(Source FRED Table M2SL for money supply and FRED Table NGDPPOT for GDP.

The importance of money as opposed to credit money, that is bank intermediation is apparent in the graph below which plots the growth in deposits vs loans for the big four banks in the USA. The green graph represents deposits and the red graph loans. We note since QE deposits have far exceeded loans.

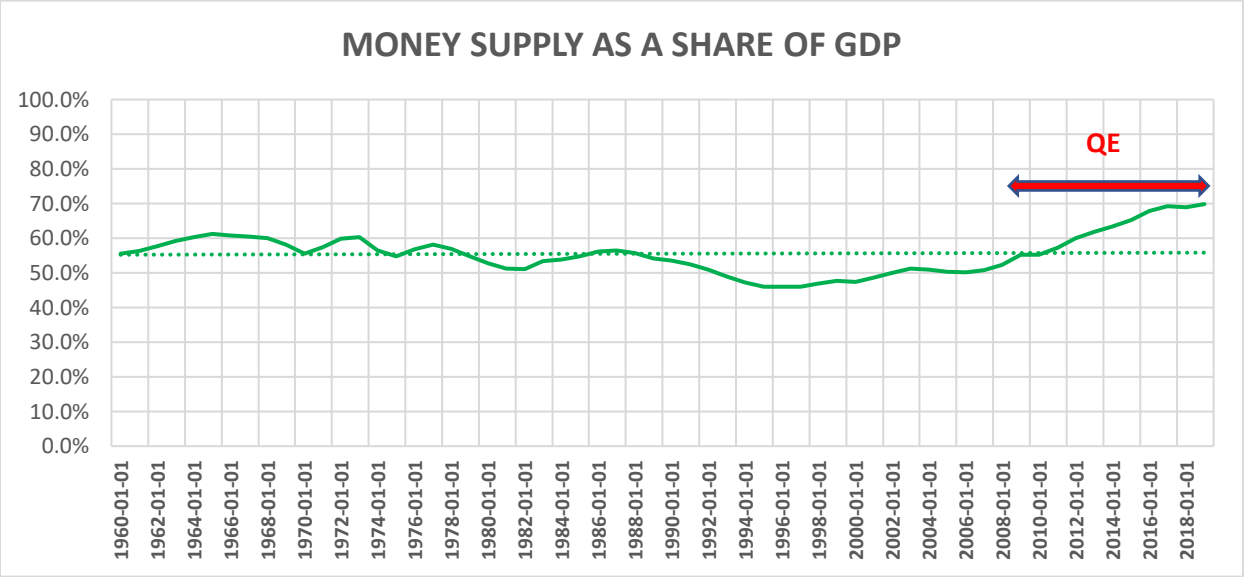
Graph 3.



(Source: Zerohedge)

And here is another interesting graph which supports the above graph. It looks at the actual money supply. We note the unusual sharp rise in the money supply post-2009 when Quantitative Easing (QE) was introduced.

Graph 4.



(Source FRED Table M2SL for money supply and FRED Table NGDPPOT for GDP.

There is an association between this rise in the FED pumping money into the economy via QE and the gap between deposits and loans. (To this should be added the additional but shorter-term effects of the Covid Relief Bills.)

Graph 5.

(Source: Zerohedge)

Clearly this poses a challenge to the perceived wisdom that only commercial banks can create money not central banks. Of course central banks can create money, but this is not credit money like banks, which is

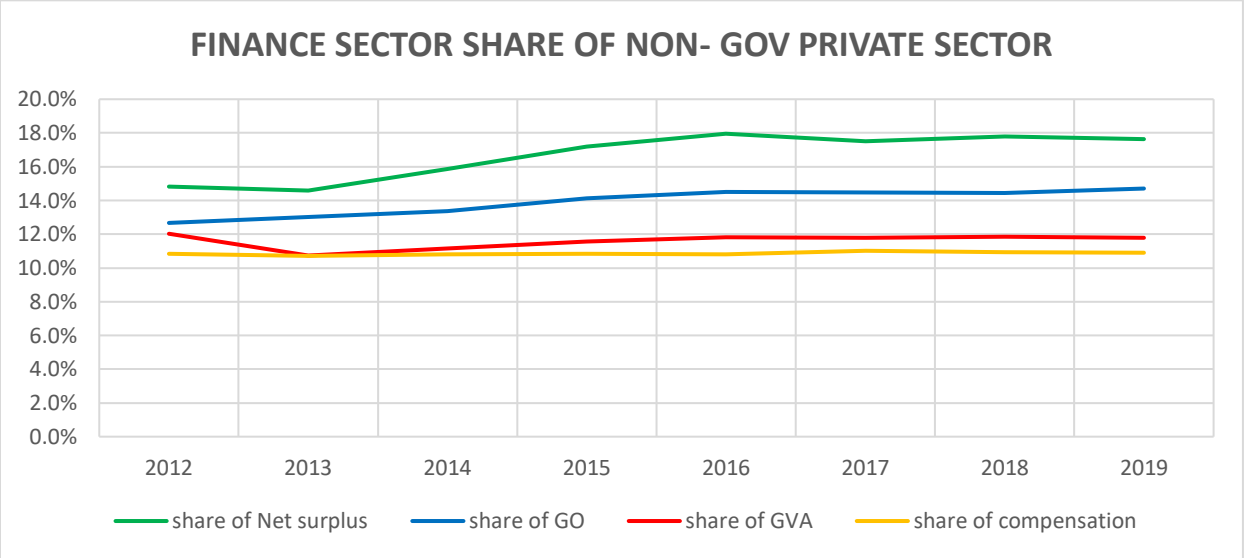
temporary because it has to be paid back. The injection of money by the FED or the BOE is as permanent as these central banks deem fit. Only when they decide to sell any of their stock of bonds, treasuries or Gilts, will that money be mopped up. In this case commercial banks will be swopping one asset for another, money for treasuries. To sum up, if every loan created a deposit as the orthodoxy holds, then loans and deposits would match which is clearly not the case.

Not only is the excess of deposits over loans evidence that central banks can expand the money supply, but it is evidence that an expanded money supply need not be utilised. The growth of the money supply relative to GDP has led many economists and analysists to conclude the normal relationship between the growth of the money supply and nominal GDP has broken down. By that they mean an increase in money supply is usually associated with a rise in nominal GDP. It has and it has not. That money has gone somewhere, but not on productive investment, instead it has fed speculation especially on the stock markets, not only directly, but also indirectly through its effect on the rate of interest.

It is worth taking a look at Graph 1 again. The movement in the money supply matches that of the industrial (business) cycle. When profits are on the rise in the upside of the cycle, banks are more willing to use their fountain pens as there are more secure opportunities to lend. The opposite is the case in the downturn. Thus there is a linkage in the growth of credit money or its shrinkage to the phasing of the industrial cycle.

This leaves only one question, how big is the finance sector given all the hype about financialisation. That is answered by Graph 6 below.

Graph 6.



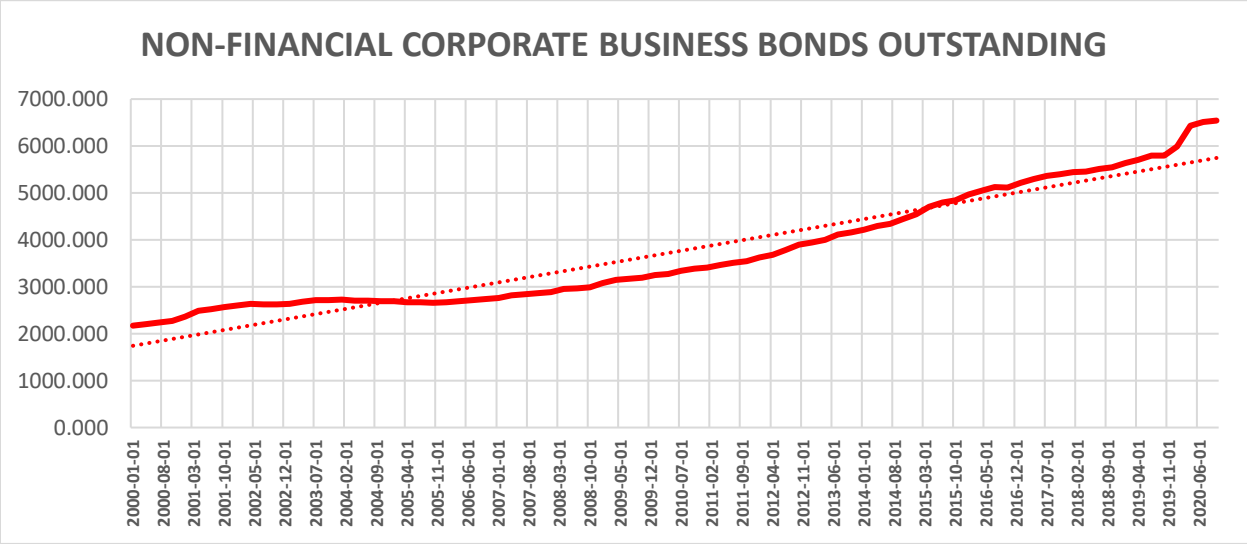
(Source: Attached spreadsheet KLEMS 2019)

I have not been able to go back as far a 1997 to grant a better perspective because the BEA is still working on the "Composition of KLEMS" tables. Nevertheless this snapshot is illustrative. In terms of worker compensation and GVA, about one in eight dollars is consumed by the financial sector stripped of the influence of FED banks as well as "owner occupied rents". This is much smaller than normally estimated. The share of net operating surplus is much bigger at close to one fifth, but that is due not only to the rise in speculation, but also the relative fall in non-financial corporate profits since 2014.

Currently, or at least in the first quarter of this year the major banks have reported spectacular profits. This is a comment from FactSet's report dated 19th April which captures all the major bank earnings reports: "*Most of these companies were in the Banks industry, including JPMorgan Chase, Wells Fargo, Bank of America, and Citigroup. This industry has the largest year over-year earnings growth rate of all five industries in the sector at **248%**. However, it should be noted that the (blended) revenue growth rate for the Banks industry for Q1 is only 3%. How is it possible for an industry to report earnings growth of almost 250% and revenue growth of only **3%**?"* So while banks overall income only increased by 3% their profits rose 248%. This was due in part to their reversal of bad loan provisions. I would argue that this reversal is premature and ill-considered, as the extent of the economic scarring, stumbling zombie companies and the plague of debt will only become known in the second half of the year.

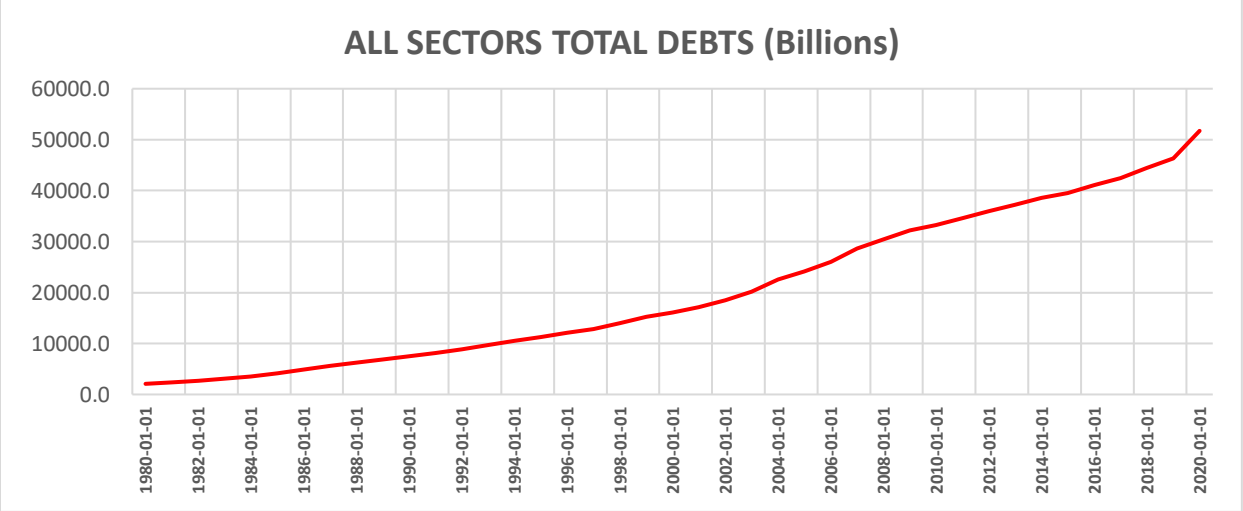
In the meantime non-financial corporate borrowing has leapt. This coincides with the fall in the rate of profit since 2014, never a good combination. (Source: FRED Table CBLBSNNCB)

Graph 7.



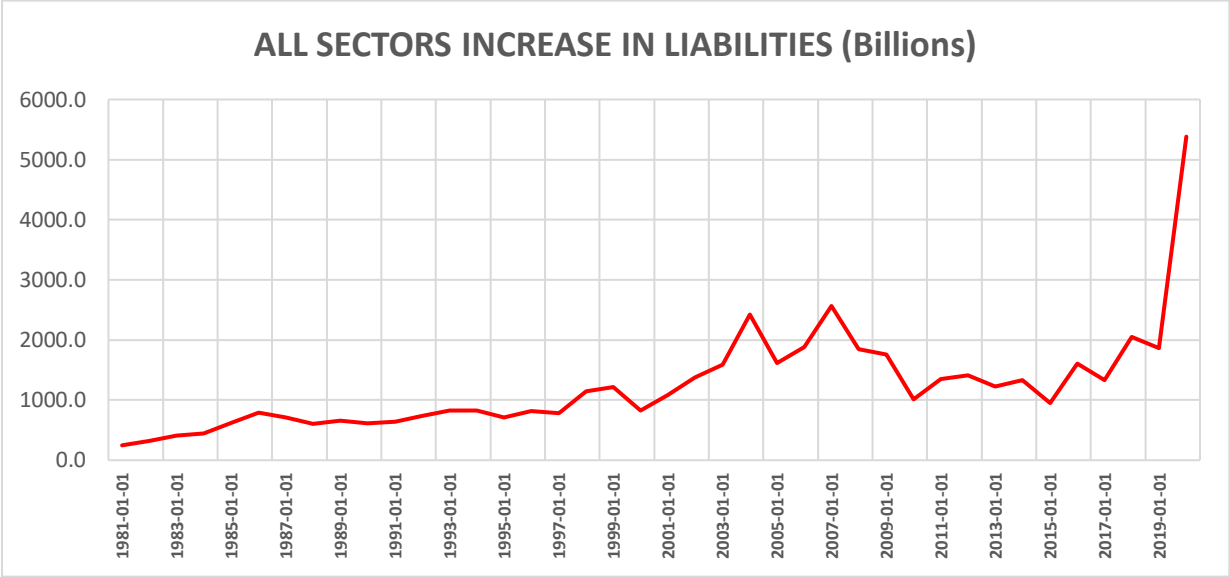
But it is not only non-financial bonds that have increased in volume, so too has total debt.

Graph 8.



Total debts have mushroomed to $51.7 trillion in 2020 or 240% of GDP (FRED Table ASTDSL). To put this in better perspective the annual increments are shown in Graph 9.

Graph 9.



It shows that the increase in 2020 was exactly double that of 2007 immediately before the 2008 financial crash (and over 40% higher even when factoring in how Covid Relief Funds expanded Government Debt). And yet the commercial banks think it prudent to reverse their bad debt provisions.

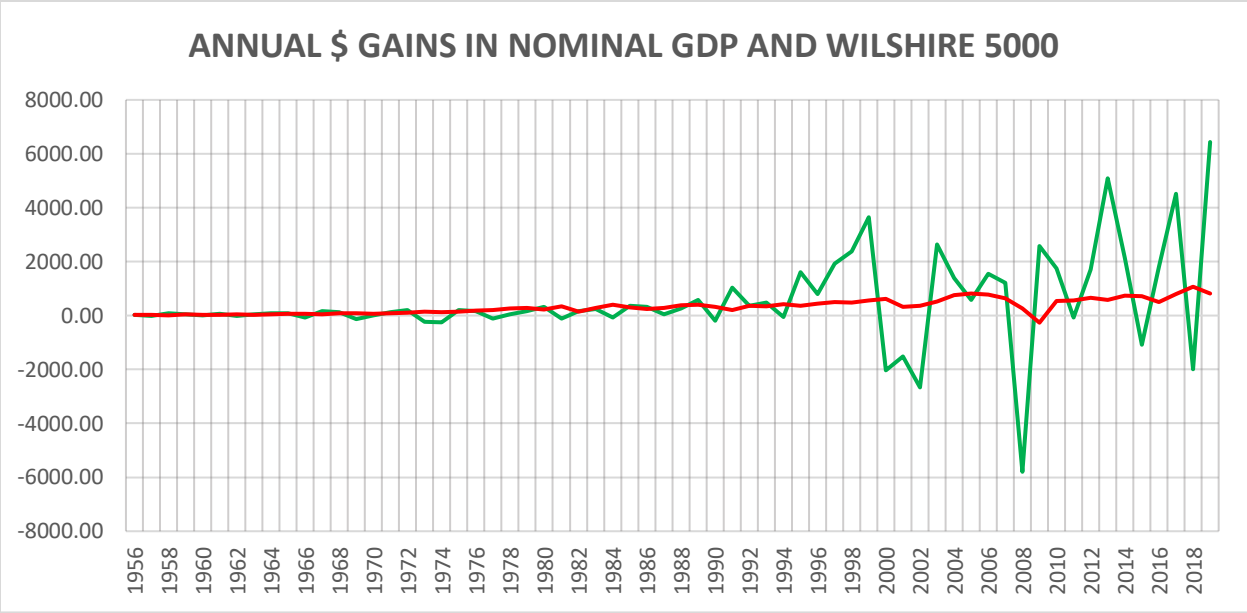
Leverage

The GDP figures correctly ignore capital gains. For example between 2014 and 2019 nominal GDP rose by $3.906 trillion while the Wilshire 5000 rose by a staggering $11.833 trillion or 3 times as much. (The Wilshire 5000 is the market cap for 97% of all list US shares.) Imagine if that had been added to GDP. It would have meant that instead of growing by 2.4% per annum in real terms, the growth rate would have jumped to 7.3%.

However, it is impossible to wall off the fictional world of shares, bonds and mortgages from the real economy. There are three overlaps. Firstly, when the financial system buys and sells these claims and profits from them, this will increase banks' net operating surplus which explains why the share of total net surplus is so much higher than its share of GVA. (See graph Graph 6 above.) Secondly the tax the government receives on capital gains, much of which is avoided and when not avoided is taxed too lightly. (Of note is how the hint of a rise in capital gains on Thursday unsettled the markets.) And finally, the biggest element of course is when claims are cashed in and spent, both by speculators, and also in the ordinary way, by pension and insurance companies harvesting there yields.

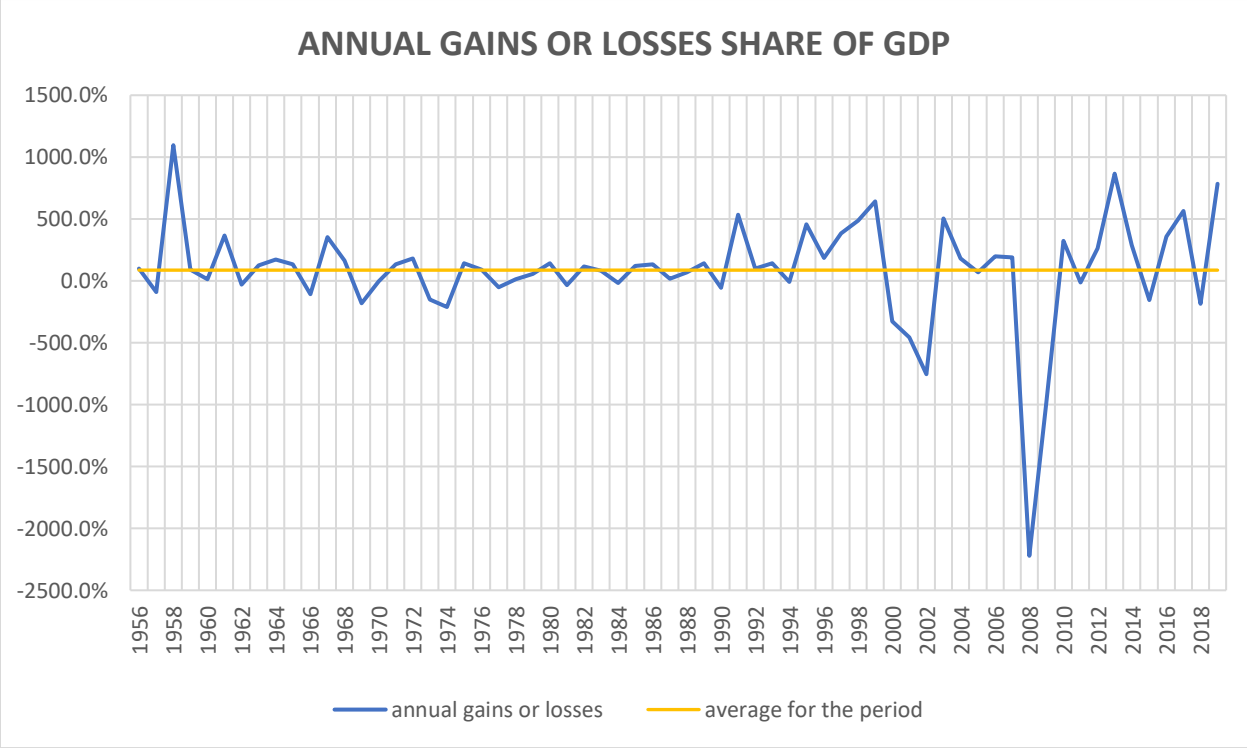
To give the BEA its due, it does try and minimize the effect of capital gains and losses on GDP. It is difficult to assess how well it has done, and even if it is possible to estimate the monetary value of the financial sector. What is true is the overlap between the real economy and the fictitious sphere is real and that it is impossible to hermetically seal the one from the other even with an "impregnable" Trump style wall. Latterly, as Graph 10 below shows, this task has become more difficult as cap gains have multiplied.

Graph 10.

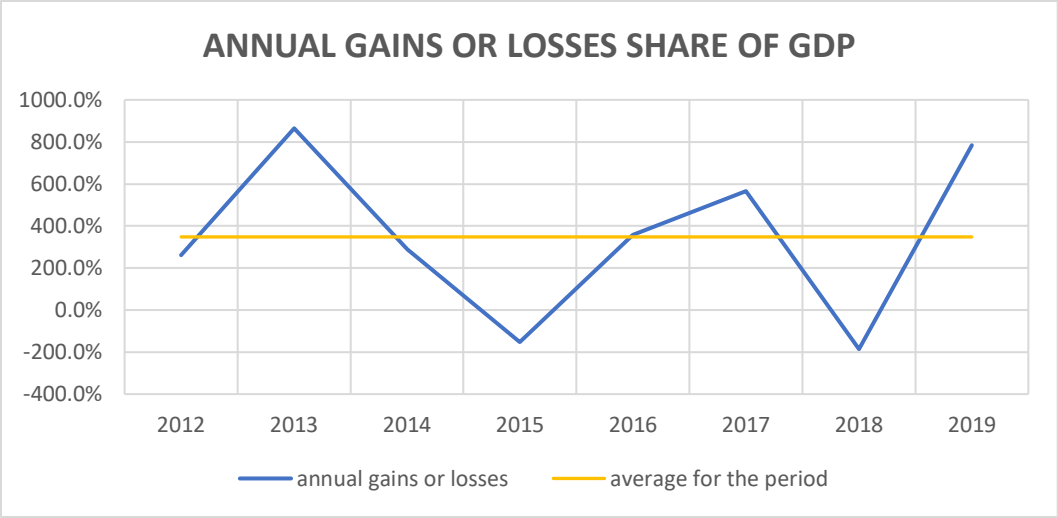


Here we see how in the run up to Dot.com bubble, capital gains soared only to crash, then to revive and to crash once more in 2008, before its volatile jump to the end of the previous decade. Over the entire period share prices rose on average 87% faster than GDP. This was due mainly to the growth in share prices since 2012 when the average shot up to 348%. This is illustrated by Graphs 10 & 11 below.

Graph 10.



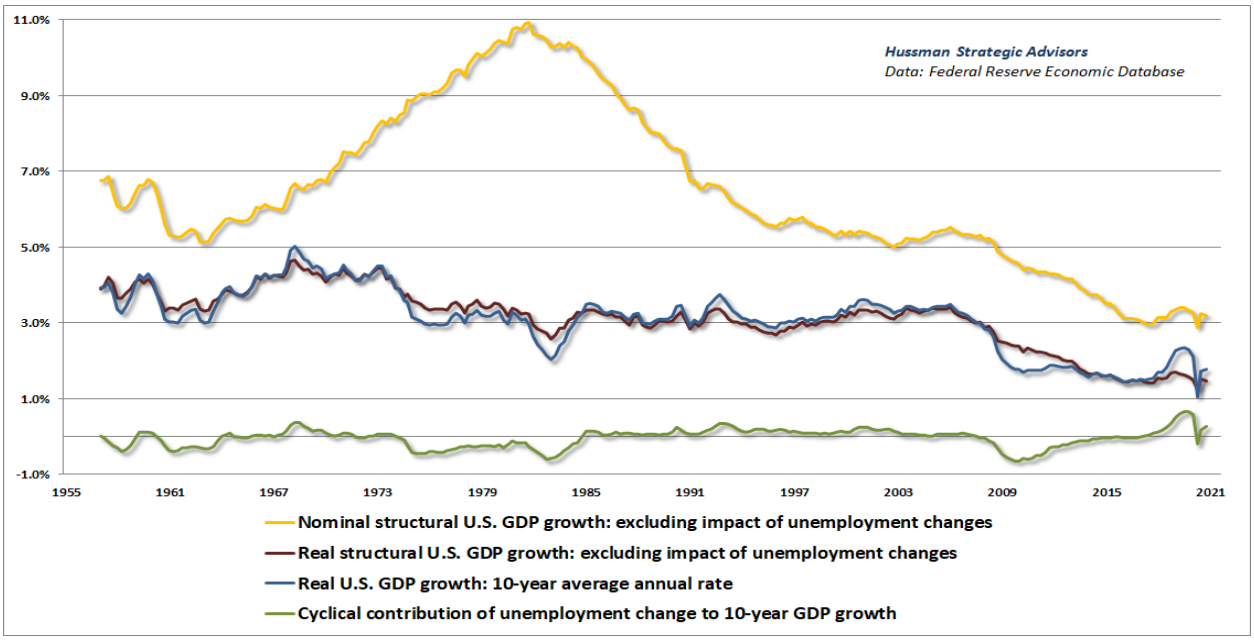
Graph 11.



This is not a healthy economy. If we were to assume just 10% of those capital gains found there way into GDP calculations, either through increased consumer spending, increased bank profits from trading, and tax, then without them, annual real growth in this period would have been 1.7% rather than 2.4%. Add in the miscalculation of inflation (an understated GDP deflator) on top of this, and since 2014 the economy has been rapidly decelerating and what growth there was, was driven not by productive investment, but by unproductive capital gains.

This deceleration in GDP despite the influence of capital gains is well captured in Graph 10 taken from Hussman Funds. https://www.hussmanfunds.com/comment/mc210411/ Hussman puts the potential growth rate of the US economy at only 1.6% currently.

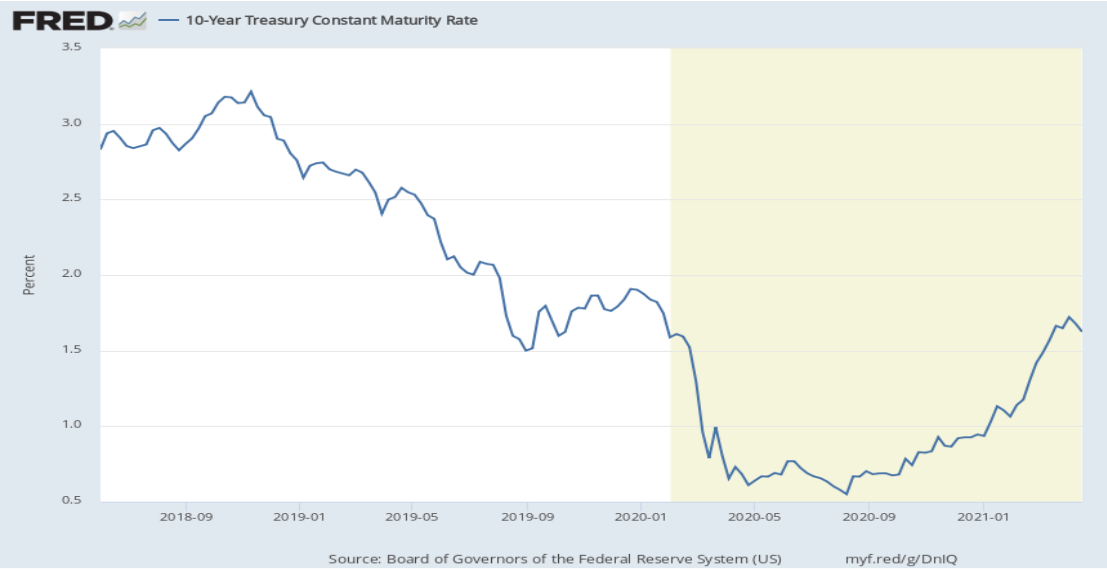
Graph 12.



Interest rates

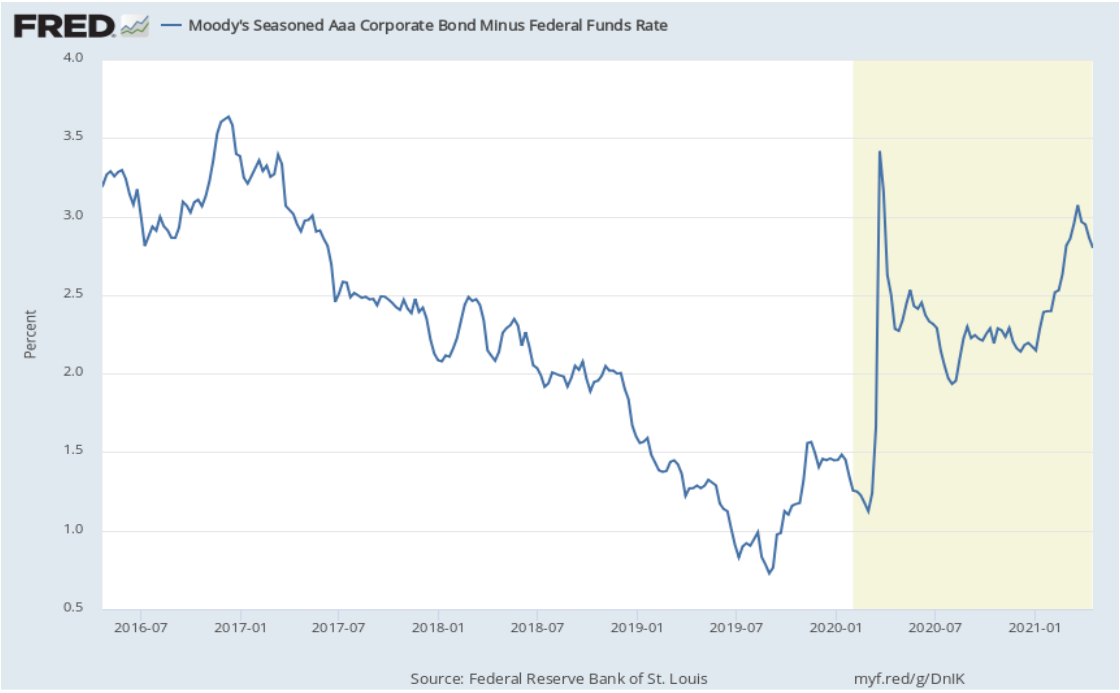
Interest rates have continued to trade in a narrow range around 1.6% despite rising inflation and consumer spending. An analysis of the FED's QE buying programme sees a pivot away from short term instruments to Treasuries proper, and from that we can assume a focus on the 10-year yield. It almost seems that 1.6% is seen as a target.

Graph 13.



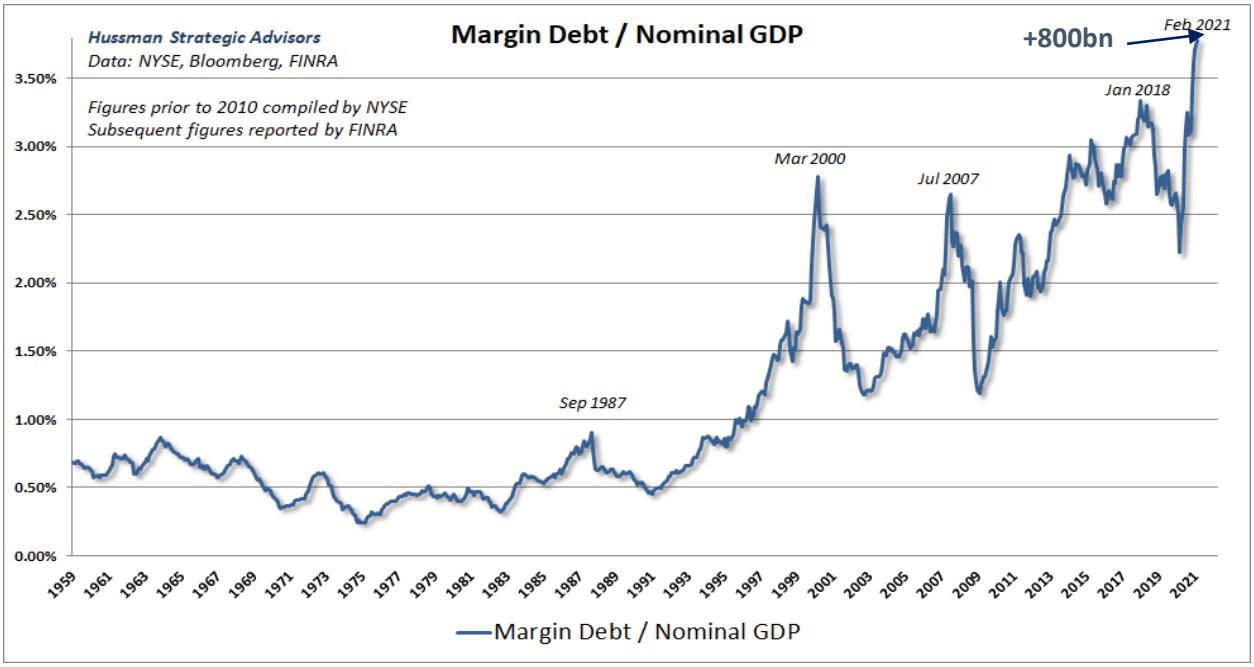
However, in the corporate world, interest rates are trending at levels last seen in 2017. And this is for the best bonds, thus interest rates outside Treasuries could produce problems in the second half of the year.

Graph 14.



The rise in interest rates have not yet had a dampening effect on leverage. Margin Debt continues to rise to historic highs. (Graph provided by Hussman Funds)

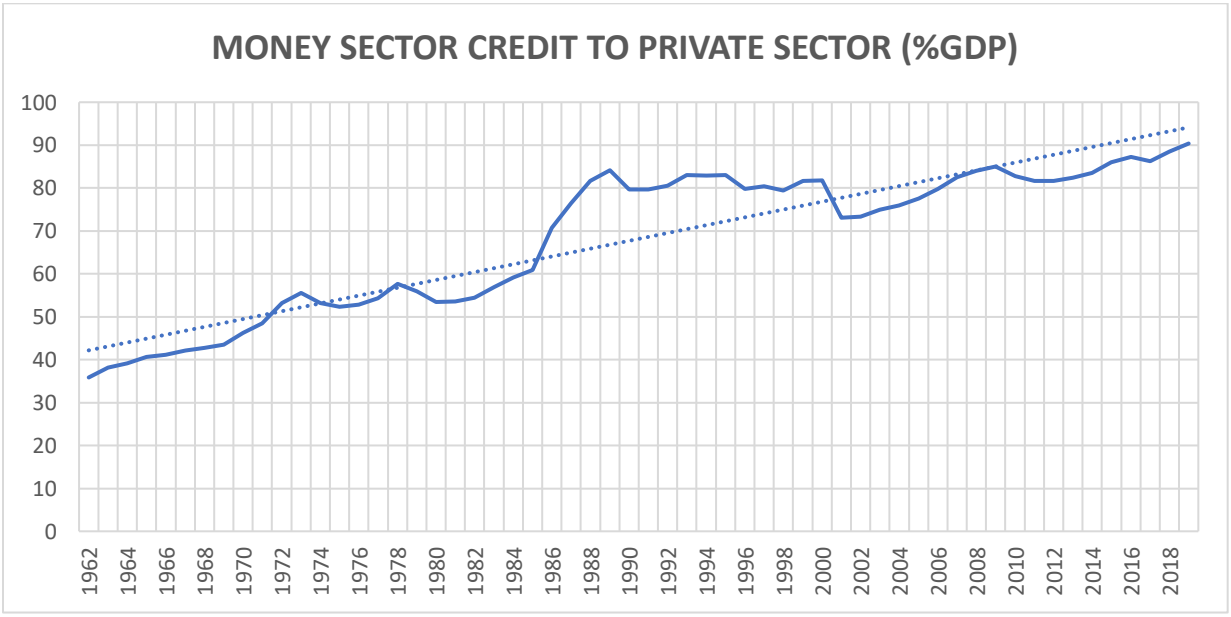
Graph 15.



Conclusion.

What is true for the USA is true for the world. Bank lending has grown latterly, approaching 90% of global, GDP and since 2016, the bulk of it has been loaned for financial rather than industrial purposes.

Graph 16.



https://data.worldbank.org/indicator/FM.AST.PRVT.GD.ZS

Another bent out of shape relationship is that of remuneration. In an article in the Financial Times on the 20th April "*For all their Enlightened Talk, CEOs are not sharing the Pain",* Brooke Masters reports that median pay for the CEOs grouped in the Russel 3000 rose by 6%. In contrast median pay for workers grouped in the S&P 500 fell by 17%. This resulted in the ratio of CEO to employee pay shooting up from 182 to 227 in S&P 500 corporations. Seems it is steak for board members and salad for stakeholders or those in the delusional ESG brigade. (In Europe however, CEO pay did in fact fall.) https://www.ft.com/content/0676c6f6-1ad2-490d-b8cf-d3bccdb76182

The total unspent consumer spring is now estimated at $5.4 trillion worldwide. Much debate centres on how much of it will go towards spending because most of it is monopolised by the super-rich. Whatever the case, currently we have seen a more rapid rebound than anticipated. But this is predicated on the efficacy of the vaccines which have now been thrown into doubt by the Indian variant which has swept through that country in a manner unforeseen by this author and others, and it is unclear if it will have a South African ending or worse. In South Africa, the variant there raged for an intense but short period and then abated.

The next month will tell. Which is why it will only be in the second half of the year that matters will become clear. If the vaccines hold and the pandemic tide retreats exposing the ocean bed, only then will we be able to see the extent of the economic debris and skeletons. Only then will the markets be forced to take stock. The 2020s will not be the roaring 20s but a very painful decade. When Biden declared this is a make-or-break decade, he is right, but for reasons that are not limited to the environment.

Brian Green 23rd March 2021.