

towards the new normal

strategic thinking in flux

- **Whilst the financial crisis has surely discredited the free-market model which has ruled the intellectual roost since the late 1970s, there is no obvious successor orthodoxy. The sheer scale of the indebtedness crisis rules out a reversion to Keynesian stimulus.**
- **Those who believe that a third great depression is inevitable are probably right. The urgent need now is for a ‘new normal’ – a framework for the post-deleveraging economy.**

The ‘New Normal’ and the denouement of irresponsibility

*“Ask any four economists and you will get five opinions –
six of them from Keynes”*

Anonymous

In recent weeks it has become very clear that the trend amongst developed world governments is to abandon the effort to revive their economies through fiscal stimulus, and to focus instead on curbing frightening deficits and escalating debts. Critics, principally of the Keynesian persuasion, believe that this is a colossal mistake, a repeat of the errors of the 1930s which will tip the global economy into what Paul Krugman has called “the third depression”¹.

Behind policies and headlines lies a fierce battle to establish a new intellectual orthodoxy to fill the gap created by the discrediting, since 2008, of the unfettered *laissez-faire* market ideology which has ruled the roost since the 1970s.

The Keynesian belief that retrenchment will create an economic slump is right, but tells only half of the story. Even if governments had stuck to stimulus policies, a deep and prolonged recession would have been inevitable anyway, through the sheer scale of the burden of debt (public, corporate and private) which has been taken on by the countries of the developed world.

The current economic slump is totally unlike all other post-War recessions in that it is **a deleveraging downturn, not a de-stocking one**. Unfettered market capitalism has burdened the system with debt, the guiding logic having been ‘want it now, pay for it later’. Well, **‘later’ has now arrived**.

Many western countries – prominent amongst them the US and the UK – have, for more than a decade, been trying to prop up a fundamentally unsustainable *variant* of the market system. Long before the 2008-09 crisis, growth had been exaggerated, debt (both admitted and off-balance-sheet) had escalated, saving had all but disappeared, and the western economies had maintained their lifestyles only by plundering posterity and by absorbing the savings of the emerging Asian players.

¹ See ‘The Third Depression’, Paul Krugman, *New York Times*, 27th June 2010

At root, **the problem has been one of reckless consumption far ahead of real earnings**. Since 2008, governments have resorted to increasingly desperate expedients – escalating deficits, near-zero policy rates and money-printing – in order to keep the party going.

This note looks at why the party is over, at what form the hangover might take, and at the possible arrival of a new, chastened and more sober basis for running developed economies. Political systems, which have found it hard enough simply sharing out apparent growth, now face the vastly greater challenge of allocating downside. It will not be pretty, but it will certainly be interesting.

Kings of the New York Streets

In an eminently readable article – “*The Econ Gangs of New York*”, published on 24th June - Joshua Brown has likened the differing schools of economic thought to the gangs that roamed the notorious Five Points district of Manhattan in the mid-nineteenth century². Mr Brown identifies eight groups of thinkers, ranging from “The Austerians” (“newly-minted deficit hawks”), via “The Double Dippers” and “The Inflationistas”, to “The New Jack Keynesians”, not forgetting “The Nihilists” (who essentially believe in the end of the world as we know it).

It must be tempting for all of us to try to decide where we fit into this microcosm of the debate. Certainly, we share some of the *longer-term* fears of the “inflationista” group, and we definitely also belong to the “new normalers” (always depending, of course, upon the definition applied to “the new normal”). Others may even read our core strategy of “dangerous exponentials” as trending towards the nihilistic end of the spectrum - in that we have warned that certain aspects both of monetary expansion and of the resource equation look unsustainable – though we would caution that *our expectation of ‘unprecedented change’ is by no means coterminous with ‘total catastrophe’*.

But the real interest in this type of categorisation should lie in two areas. The first is that it highlights the extent to which strategists are in flux, because **the events of 2008-09 have dethroned the prevailing orthodoxy without putting anything new in its place**. Second, and even when disagreeing on pretty much everything else, most of these groups seem to share an essentially gloomy perspective on the economic outlook.

In many respects, the debate between the various different economic ‘gangs’ may seem somewhat esoteric. But the reality is that it has huge practical implications, not least because it is driving the confrontation between debt-cutters and fiscal stimulators. Longer term, the outcome of this debate – by which we mean the eventual destination of intellectual primacy – will determine the future shape of policy, of regulation and of the nature of markets. Here, we survey the battleground that Mr Brown has so neatly encapsulated before assessing the probable outlook.

² See Joshua Brown, ‘*The Econ Gangs of New York*’ <http://www.thereformedbroker.com/2010/06/24/econ-gangs-of-new-york/>

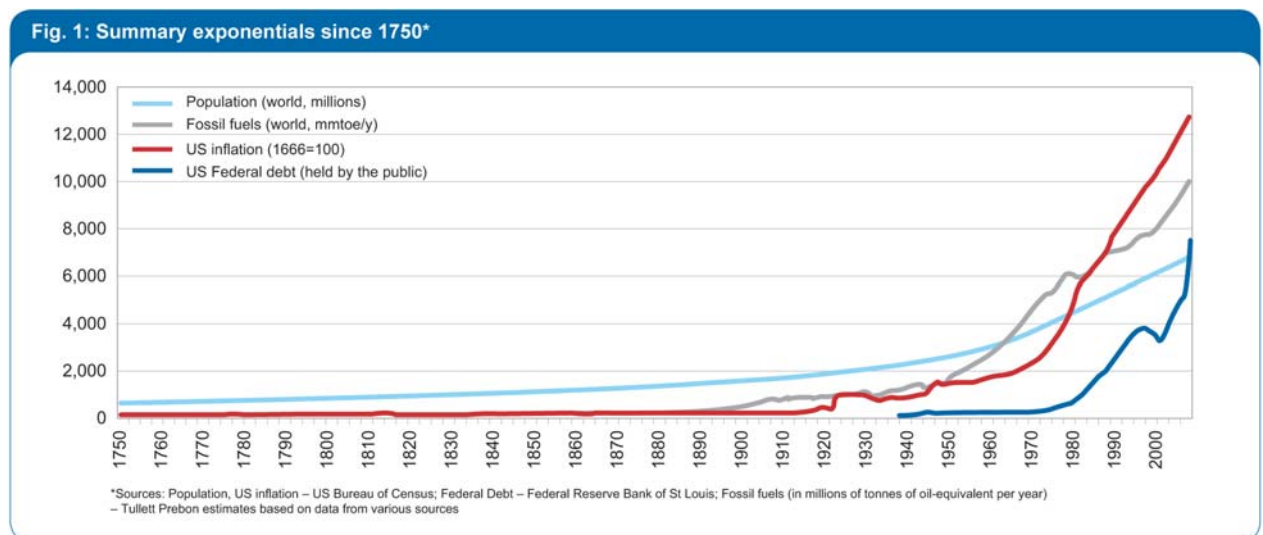
Points of departure

No-one comes to such a debate completely free from established beliefs. The “New Jack Keynesians”, for example, “tend to be from the left, and it’s been said that they’ve never met an expenditure they didn’t like”³. The “V Shapers” are intrinsic optimists, whilst many of the “Double Dippers” have never really believed in a recovery at all. An “Inflationista”, Mr Brown says, “sees the potential for inflation everywhere he looks”, whilst the “Nihilists” must have arrived at their conviction – which is that “nothing can be believed in, not government, not capitalism, not brick-and-mortar” – long before the financial crisis.

Likewise, our own start-point, and the prism through which we view this debate, is our belief that the economy is in the grip of a process of “dangerous exponentials” which operates across financial and non-financial determinants alike. In brief, we believe that monetary measures such as inflation, the money supply and debt have adopted unsustainably exponential trajectories, as have critical non-financial indicators such as population and energy consumption.

This interpretation has been outlined in detail in an earlier report⁴, and is the subject of a planned follow-up in which we shall examine the possible shape of the economy after the *denouement* of the exponentials process. For present purposes, it need only be explained that our core principles are (a) that the exponentials process is nowhere properly understood, and (b) that the economy is an energy construct.

It may well seem – simply from a glance at fig. 1 – that the unsustainably exponential nature of various financial and non-financial indicators (such as inflation, debt, energy consumption and the global population) is blindingly obvious. But exponential patterns only become apparent if the observer uses a vastly longer timescale than is customary amongst investors or policymakers.



* Sources: population, US inflation – US Bureau of Census; Federal Debt – Federal Reserve Bank of St. Louis; Fossil fuels (in millions of tonnes of oil-equivalent per year) – Tullett Prebon estimates based on data from various sources.

³ See Brown, op cit

⁴ Tullett Prebon Strategy Insights, issue five, *Dangerous Exponentials*, May 2010

The contenders

The sheer variety of the interpretations on offer, so aptly summarised by Joshua Brown, is in sharp contrast to the last great 'change of the guard'. This took place in the late 1970s, when the post-war Keynesian orthodoxy was supplanted by a then-new market-oriented philosophy which has variously been labelled 'monetarism', 'the Anglo-American model' and 'the Washington consensus'.

This transference of authority was by no means immediate, seamless or straightforward, of course, but at least interventionism and *laissez-faire* were the only games in town. As we have explained before⁵, two conditions – one pragmatic, the other intellectual - usually need to coincide before a change of the economic guard can take place. First, there needs to be some strong and practical evidence that the existing orthodoxy has failed. Second, there needs to be a coherent alternative ready and waiting to take its place.

The difference this time is that we have the former condition without the latter, **the practical failure without the intellectual alternative** – whilst the 2008-09 crisis seemed to prove beyond peradventure the failure of the ruling *laissez faire* orthodoxy, no ready-made alternative was readily to hand.

The nearest thing that we have to an intellectual 'official party of opposition' is the Keynesian group, of whom Nobel laureate Paul Krugman is rightly identified by Mr Brown as the leader. Prof. Krugman has articulated the Keynesian analysis better than anyone, most notably in his *The Return Of Depression Economics*⁶. In that seminal work, Prof. Krugman did *not* contend that the world was going into a depression but, rather, that the debate over the prevention of depressions had become relevant again after half a century of complacency. One by-product of this complacency was a neglect of demand-side economics, with policymakers preferring to emphasise instead a supply-side "crank doctrine". Demand-side management, Prof. Krugman insisted, needed to be re-learned, and fast, if a full-blown slump was to be avoided. As of 2009, fiscal stimulus had been applied correctly, but too timidly. Prof. Krugman is sufficiently candid to admit that stimulus didn't work in Japan, but argues that it was implemented too late in the day.

In a recent article⁷, and whilst in no whit retreating from his intellectual position, Paul Krugman has adopted a much gloomier tone, arguing that the essential policy of stimulus, having been implemented too timidly, is now facing reversal. "We are now", he fears, "in the early stages of a third depression" (explaining that the first depression followed the 1873 panic whilst the second followed the Wall Street Crash of 1929). The root cause of the likely descent into depression is that "governments are obsessing about inflation when the real threat is deflation, preaching the need for belt-tightening when the real problem is inadequate spending". Somewhat waspishly, Prof. Krugman describes the current reversion to the policy mistakes which triggered the Great Depression as "the victory of an orthodoxy that has little to do with rational analysis, whose main tenet is that imposing suffering on other people is how you show leadership in tough times".

Based as it is upon a Keynesian philosophy which many regard as tried and tested, Prof. Krugman's position is a strong one, but it does not really address the problems raised by opponents who are not *all* self-interested cranks. The "austerians" – a term which necessarily reminds us of the hard-line monetarist "Austrian school" of economists – are deficit hawks who are worried about the implications of escalating debt and unsustainable deficits. The views of the hawks can be regarded as the polar opposite of those of the Keynesians. Their fear is that escalating debt will drive interest rates upwards – to the huge detriment of the economy – unless deficits are brought under control.

⁵ See Tullett Prebon Strategy Insights, issue two, *Brave New World?*, March 2010

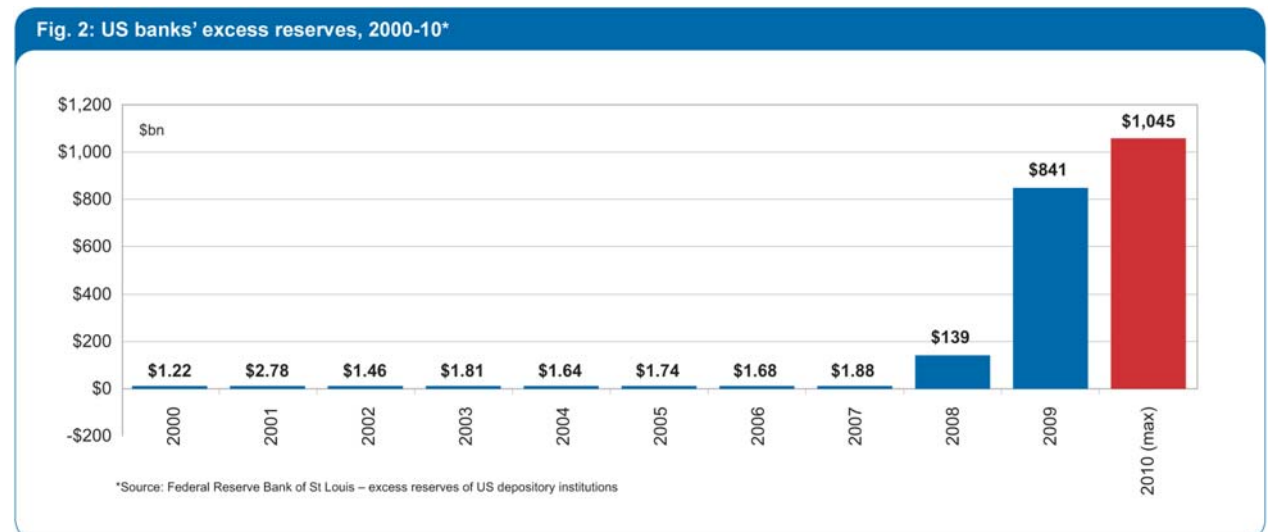
⁶ Paul Krugman, *The Return of Depression Economics*, 2009

⁷ See 'The Third Depression', Paul Krugman, *New York Times*, 27th June 2010

A closely related group are the “inflationistas”, who use classic monetarist logic (pointing at ultra-low interest rates and rapid monetary expansion) to warn of the dangers of rampant inflation despite current statistics which, at least in the short-term, show precisely the opposite. One economist concerned about inflation, Allan Meltzer, pointed, in a May 2009 article⁸, to the “enormous increase in bank reserves” as another potential harbinger of inflation (and US banks’ excess reserves, as depicted in fig. 2, certainly show an unprecedented build-up). That stance, which describes the administration’s stimulus approach as “an obstacle to sound policy”, is obviously the diametric opposite to the remedy recommended by Paul Krugman.

Aside from the “new normalers” – of whom more shortly – we can conclude our review of the intellectual battleground by observing that, whilst the “double dippers” do not believe in a real recovery any time soon, the “v shapers” believe that the economy is already recovering very strongly. The latter tend to come from the sell-side, and their arguments often seem to be based, as Joshua Brown puts it, on “manipulated bottom-line profit reports against easy comps”⁹. Until quite recently, this group could point to strong equity market rebounds in support of their optimistic thesis. Our consistent view has been that, throughout 2009, equities recovered largely in the face of the facts. In their gloomy prognostications, the “double dippers” – who might equally be termed ‘flat-liners’ – seem to us to be much more in tune with reality.

But the key point, we think, is that most of these groups agree on one thing at least, **which is that we are now in uncharted waters**. They may disagree fiercely on the ‘how’ and the ‘why’, but their views seem to converge either on a third depression or on a complete break with the past.



* Source of data: Federal Reserve Bank of St. Louis – excess reserves of US depository institutions

⁸ Allan Meltzer, *Inflation Nation*, New York Times, 3rd May 2009

⁹ See Brown, op cit.

What is ‘the new normal’?

In the immediate aftermath of the 2008-09 banking crisis, there was a widespread belief – most evident in the strong rebound in markets – that the world had somehow ‘got away with it’. Though the banking system had tottered on the brink of collapse for much of the latter part of 2009, government intervention had ‘saved the world’ – or, at least, appeared to have done so. Government actions certainly prevented an *immediate* systemic banking implosion, a catastrophe which came frighteningly close to happening in September and October 2008.

Perhaps reflecting relief that the economic world had not, after all, come to an end, markets rallied strongly, most notably in equities but also in other asset classes (such as commodities). Reactions to the economic state of affairs naturally varied according to the standpoint of the observer. Some were concerned with the supposedly iniquitous behaviour of bankers, who had paid themselves huge bonuses in good times but scurried to the taxpayer for bail-outs as soon as their risk-taking turned sour. Others believed that the fundamental resilience of the system had been proven, even if the balance between the public and private sectors would necessarily be different in the future. Still others believed that 2008-09 represented a fundamental and irreversible change, and that reversion *in toto* to the previous model was impossible.

The latter view – that there has been fundamental and irreversible change - is probably the nearest that one can get to an over-arching definition of “the new normal”. Joshua Brown identifies the leading lights amongst the “new normalers” as John Mauldin, and PIMCO bosses Bill Gross and Mohamed El-Erian. These are certainly amongst the most acute observers of the economic and financial scene. Mr El-Erian has defined the principle characteristics of “the new normal” as “muted growth overall, a protracted need for balance sheet rehabilitation, accelerated migration of growth and wealth dynamics to systemically important emerging economies and relatively weak global governance, [together with] notable government involvement in the context of convergence among systemically important countries toward, for lack of a better term, state capitalism”¹⁰.

“In industrial countries,” Mr El-Erian continues, “this involves the public sector playing a larger role in defining the (reduced) areas where markets operate relatively freely. In emerging economies, it involves the government providing more freedom to market forces within the (growing) areas it defines.”

Game-change - evidence for a New Normal

An appreciation of the fundamental change ushered in by the events of 2008-09 needs to begin with a clear understanding of what has actually happened. Essentially, government interventions were effective, but only when seen as a fire-fighting exercise – they averted the *immediate* risk of catastrophe, but did not address the underlying weaknesses of the system.

For a start, all that government really did, where the banking sector is concerned, was to buy time by transferring liabilities from the private to the public balance sheet through a process for which our shorthand is ‘TAT’ (toxic asset transference). Since governments are generally reckoned to be a lower risk than private or corporate borrowers, this contributed to a lowering of yields, which in turn averted an immediate rates crisis whilst simultaneously enabling banks to start rebuilding their balance sheets through a dramatic widening of spreads.

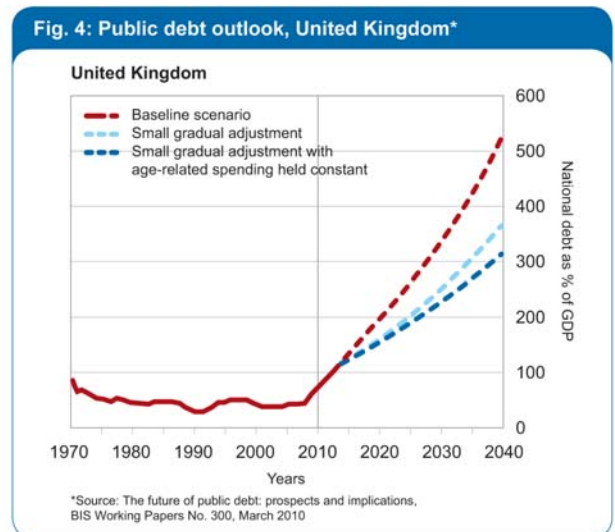
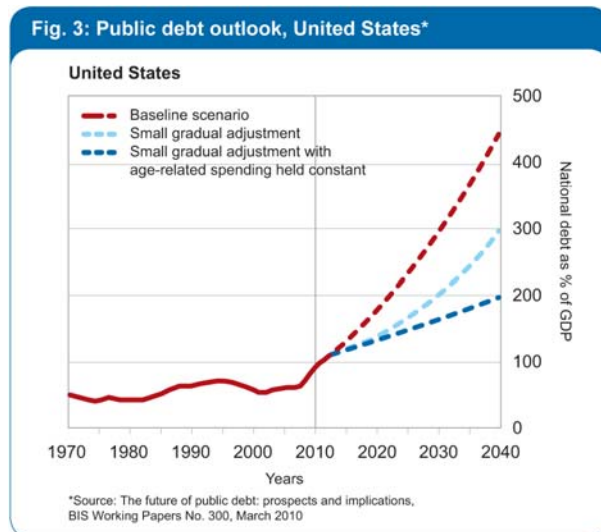
But debt did not, of course, ‘go away’ simply by being transferred from banks to governments. In this sense, the sovereign debt crisis of 2010 was the logical *and inevitable* sequel to the banking crisis of 2008-09, the fundamental difference being that, whilst governments can bail out banks, no institution – not even supra-national entities like the IMF - really stands ready to bail out governments.

¹⁰ <http://www.pimco.com/LeftNav/PIMCO+Spotlight/2010/Secular+Outlook+May+2010+El-Erian.htm>

Necessarily, sovereign debt worries focused initially on the governments which were most exposed either through the scale of their outstanding debt or the extent of their ongoing deficits, with deficits clearly more significant than absolute debt levels (which explains why Britain, with comparatively modest initial debt levels and long average maturities, but with a frightening deficit, has fared at least as badly as Italy, which has the mirror-image characteristics of higher debt but smaller deficits).

If, as a result of the TAT process, sovereign debts had simply increased in a one-off manner, the problem might have been containable. However, and as we have explained before¹¹, a study by the highly respected Bank for International Settlements (BIS) has shown that sovereign debt has begun to adopt unmistakable (and wholly unsustainable) exponential trajectories in most developed world economies¹². Just two of the BIS charts – those for the US and the UK – are reproduced here (figs. 3 and 4), but this is an OECD-wide phenomenon. Moreover, and as the BIS study makes clear, banking sector interventions are not the primary cause of this process, which results not from one-off interventions but, rather, from unsustainable deficits in ongoing budgets.

These potential trajectories are truly unsustainable because, even on the (improbable) assumption that rising debt does not drive up interest rates, debt service costs would absorb an ever-larger proportion of GDP, thereby embedding deficits and turning the debt process into something which we term a “vortex”. Indeed, describing it as a ‘death spiral’ might not be too far wide of the mark. This vortex threat seems to supply powerful ammunition to those policymakers who believe that deficit stimulus is no longer an option, irrespective of the theoretical merits or demerits of the pure Keynesian prescription.



¹¹ See Tullett Prebon Strategy Notes, issue six, *Out of Control*, 12th May 2010

¹² See *The future of public debt: prospects and implications*, BIS Working Papers No. 300, March 2010

In any case, the return, to date, on fiscal (and other) stimulus measures looks pretty meagre. Taking the UK simply as an example, the deficits incurred during the last two fiscal years (totalling £250bn) equate to 17% of current GDP (£1.48tn). A further £200bn (14%) has been injected through quantitative easing (QE). Yet the independent Office for Budget Responsibility (OBR) predicts real growth in 2011 of 2.3%, equivalent to about £35bn. Considered as a return on the sums pumped into the economy, it would be very difficult indeed to describe this as an even remotely viable ratio. Keynesians would, of course - and with some reason - retort that the downturn in economic output would have been very much worse without intervention. But we continue to suspect that **the simple stimulus-response mechanism has not been functioning as theory (and past experience) say that it should.**

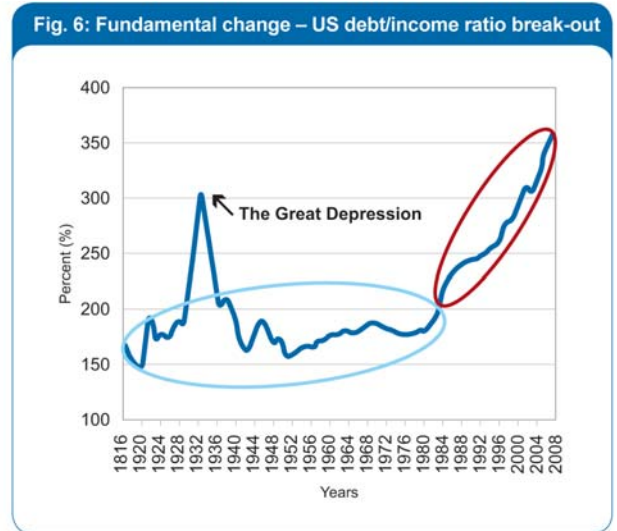
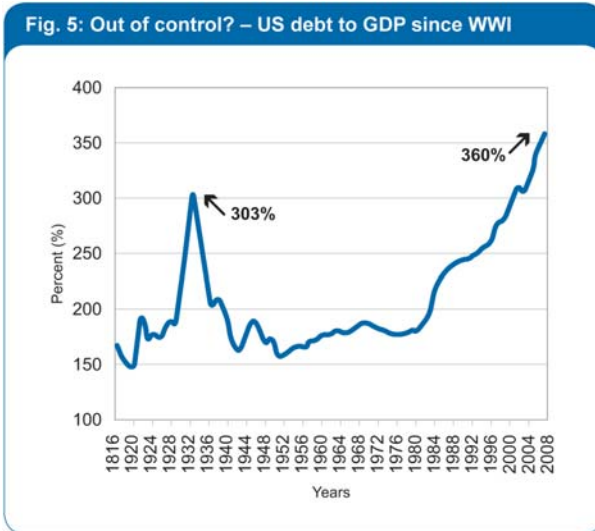
Overall, then, growth remains ultra-sluggish despite a combination of (a) huge quantities of stimulus injection, (b) the use of QE an unprecedented scale, and (c) sustained near-zero policy rates. Effectively, then, governments have thrown everything but the kitchen sink at the problem, with very little result. This does not necessarily show that the Keynesian theoretical framework is wrong. But it *does* suggest to us that two tentative conclusions should be considered.

The first of these is that **the scale of the developed nations' underlying economic weaknesses may be of a magnitude that simply overwhelms the Keynesian calculus.** The second is that **some kind of fundamental process is now unravelling.** The latter conclusion is *our* definition of "the new normal". We therefore need to understand exactly *what* is now unravelling, and why it is doing so.

The Party and the Hangover

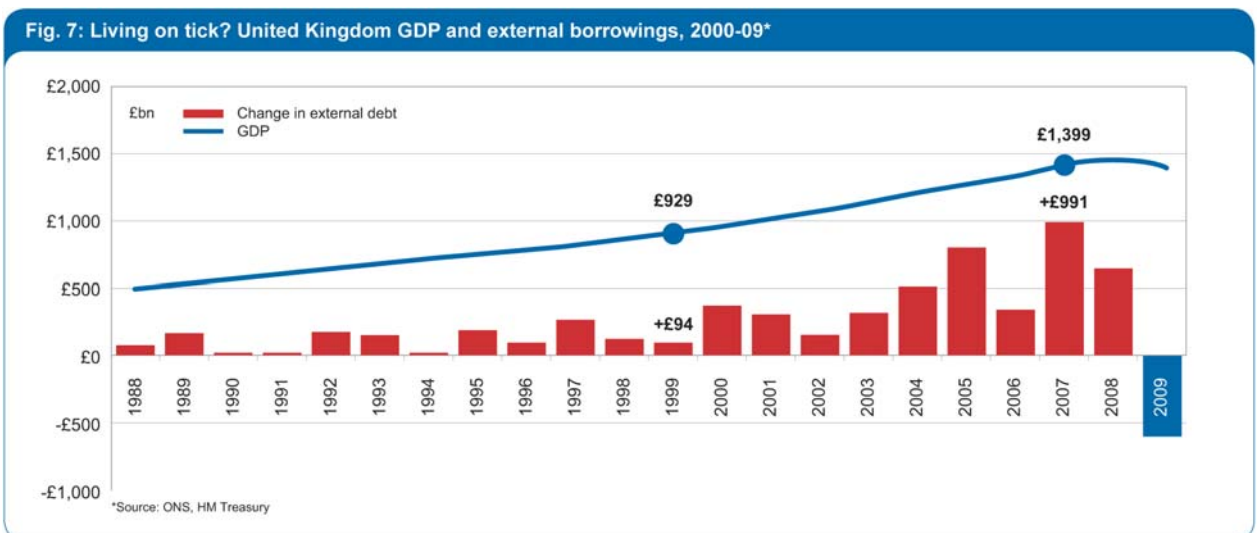
What is unravelling, of course, is a historic and irresponsible (and now wholly unsustainable) build-up of debt exposure in most developed countries. Of course, to say that 'the western economies have accumulated unsustainable levels of debt' is about as insightful as saying that 'the German football team beat England because they scored more goals'. What we need to examine is the scale of the problem, and how it has come about. Here, charts can provide some useful insights.

Fig. 5 summarises the relationship between GDP and all credit market debt – the sum of public, corporate and private borrowings – in the United States since the First World War. The first obvious feature of the chart is the peak (of 300%) which occurred in the 1930s. This, it should be noted, did *not* reflect a sudden increase in outstanding indebtedness – rather, it resulted from a sharp fall in GDP during the Great (second) Depression, and it also provides a copy-book example of the way in which deflation exacerbates the proportionate impact of debt exposure. Thereafter, the ratio declined rapidly, as the economy recovered (and deflation reversed) in the second half of the 1930s, a process to which pre-war rearmament made a significant contribution. Despite an increase during the Second World War, debt remained in the 150-200% range until the early 1980s. The increase since then – which has carried debt exposure to 360% of GDP *despite strong apparent economic growth* – is wholly unprecedented.



* Source: PIMCO, Investment Outlook June 2010. Annotation: Tullett Prebon

Fig. 6 amplifies this interpretation by showing the decisive nature of the break-out which has occurred since the 1980s. Essentially, America’s debt-to-income ratio has risen from a historical 1.7-2.0x to an unprecedented 3.6x. A Keynesian would, of course, lose no time in pointing out that this break-out coincided with the triumph of free-market monetarism over the post-War Keynesian consensus. Though we disagree with the Keynesian *prescription* – because one cannot borrow one’s way out of excessive leverage – we accept, as a *simple statement of the facts*, the Keynesian observation that **the relationship between debt and income has undergone a fundamental (and, we think, disastrous) change during the era of unfettered free-market economics.**

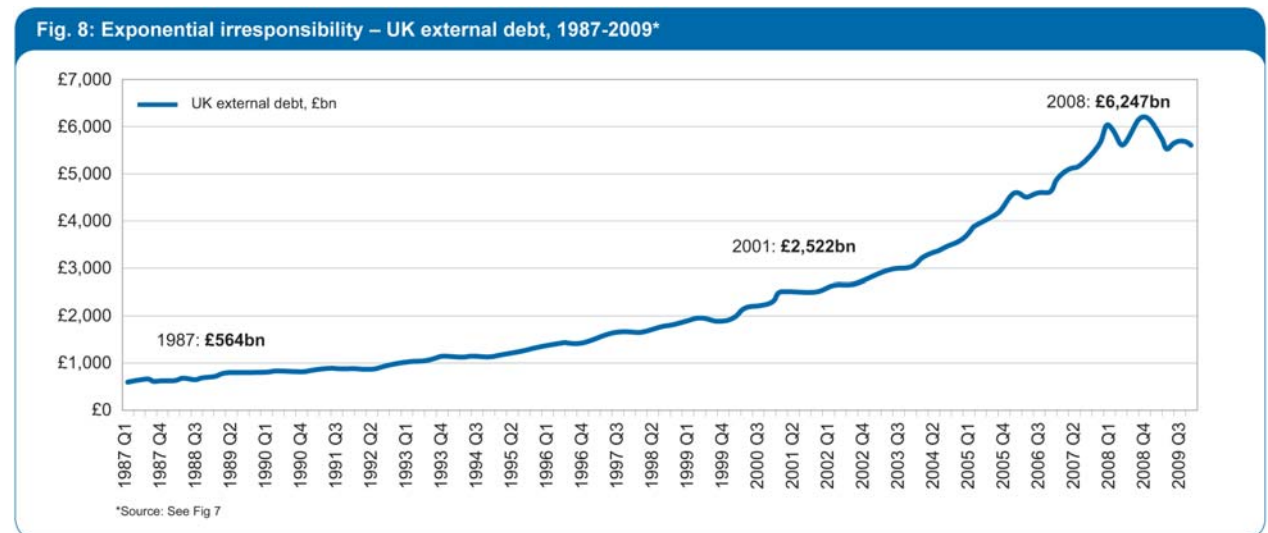


*Source of data: ONS, HM Treasury

In fig. 7, we set out another dimension of the debt dynamic, looking this time at Britain rather than at the US. In this chart, we use ONS¹³ data to compare GDP with increments to external debt. Though there are various methodological caveats to the use of external debt data, the broad picture is surely clear enough. Since the early 2000s, **Britain has sucked in vast amounts of overseas borrowings**. At the peak of this process, in 2007, the UK borrowed an additional (and surely ludicrous) £0.71 from foreign lenders for each £1 of national income. Between the end of 2001 and the end-2008 peak, British external debt increased by almost 150%, from £2.5tn to £6.2tn (see fig. 8). Simply put, the UK borrowed £3.7tn from foreign lenders in the space of just seven years.

This process can in turn be linked to domestic trends, most importantly (though by no means only) to the boom in property markets between 2000 and 2007. During that period, the banking system disbursed huge sums in mortgage finance, the overwhelming majority of which came, by definition, from overseas, since the domestic savings ratio had all but disappeared. Since the majority of this overseas funding had been raised on short-term wholesale markets, the UK was necessarily hugely exposed to any interruption to those markets.

Though mortgage finance was the biggest single component of the UK borrowing binge, other debt categories contributed materially. One of these was consumer credit. Combine the consumer credit expansion with the scale of equity release – which, in 2007, accounted for a barely-credible 39% of all new mortgage issuance, whilst just 35% went into the actual purchase of residences¹⁴ – and the apparent buoyancy of the consumer sector becomes altogether understandable. Consumer spending was, of course, the engine of growth in the economy during this period, and it is evident with hindsight – and surely should have been apparent at the time – that **all (indeed, more than all) of this consumer-driven growth was actually being borrowed from overseas lenders**.



*Source of data: see fig 7.

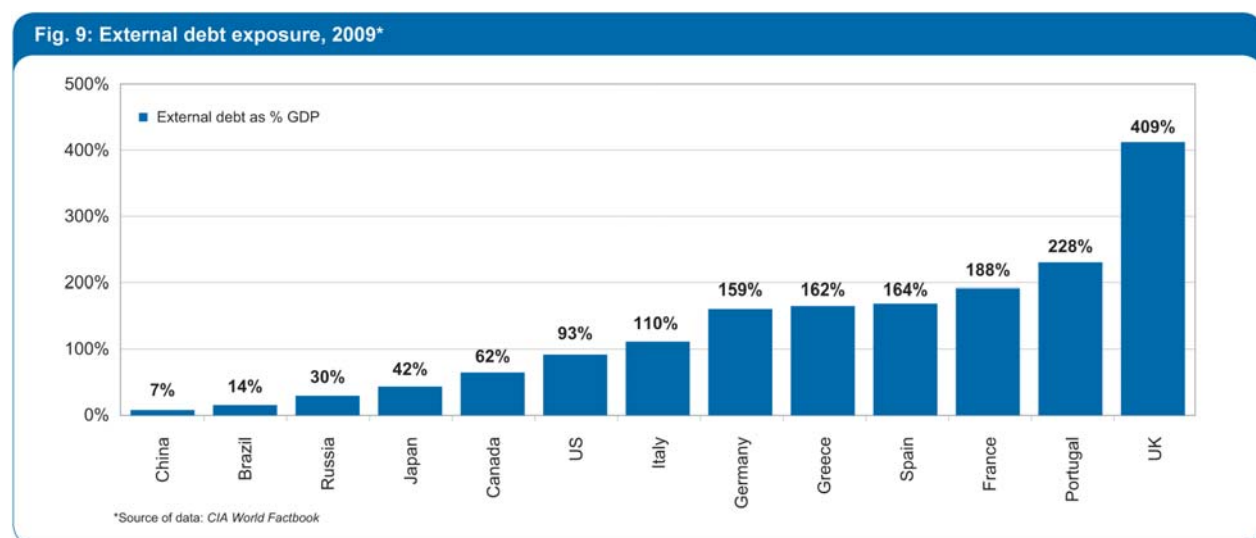
¹³ Office for National Statistics

¹⁴ Source: FSA – Address by Adair Turner: *The Mortgage Market: Issues for Debate*, 12th May 2009

Though Britain provides a rather extreme example of this binge borrowing – which was channelled into consumer spending and into creating a property price bubble – most other OECD countries' under-regulated markets permitted the same process to occur. Reflecting this, most are burdened with huge external obligations (see fig. 9). As we have explained in previous research, it is vital to distinguish between overall and external indebtedness – the debts which a country's citizens owe to each other are manageable in a way that debts owed to foreign lenders simply are not.

Excluded from this chart are Ireland and Iceland – the figure for the former would frighten small monkeys, whilst, in the case of Iceland, even the number seems difficult to gauge¹⁵. Amongst the larger economies, the scale of external indebtedness of the European countries – including the UK and France as well as the Eurozone 'PIIGS' – helps to underscore the impression, derived from public debt ratios, that Europe as a whole is dangerously indebted.

Whilst the 93% external debt ratio for the US may not look too worrying, this measure fails to reflect a hugely important factor identified by, amongst others, Chris Martenson¹⁶. This concerns off-balance-sheet debt. According to Mr Martenson – and to other available sources – **the off-balance-sheet obligations of the US government totalled \$49.1tn at the end of 2008, equivalent to about 350% of American GDP**. (The figure increased again, to \$52.15tn, during 2009). Add government debt to these off-balance-sheet obligations and the total equates to more than 400% of GDP. Moreover, Mr Martenson believes that this aggregate number is growing at a trend rate of almost 5% per year. Simple mathematics suggests that, if gross government obligations represent 4.0x GDP and are increasing by 5% annually, the ratio must continue to worsen unless annual GDP growth can exceed a wildly improbable 20%.



*Source of data: CIA World Factbook

¹⁵ According to the *CIA World Factbook*, the most recent available number for Icelandic external debt dates back to 2002.

¹⁶ <http://www.chrismartenson.com/blog/whats-total-debt-gdp-ration-us/11673>

Conclusion – the implications of the Great Unravelling

What we have identified, thus far, then, is that most western economies have become trapped in a process which looks unmistakably like **a debt vortex**. These countries' national debts and associated deficits – the factors which have spooked the markets thus far – represent the tip of an iceberg which also includes external debts and off-balance-sheet obligations.

This indebtedness can be traced to a variety of causes, but *the common denominator is irresponsibility*. Given the severity of this situation, a deleveraging process – of which falling US commercial lending (fig. 10), and widespread governmental retrenchment, are but two examples amongst many – is anything but surprising. Indeed, deleveraging is the unavoidable *and inevitable* consequence of prior recklessness.

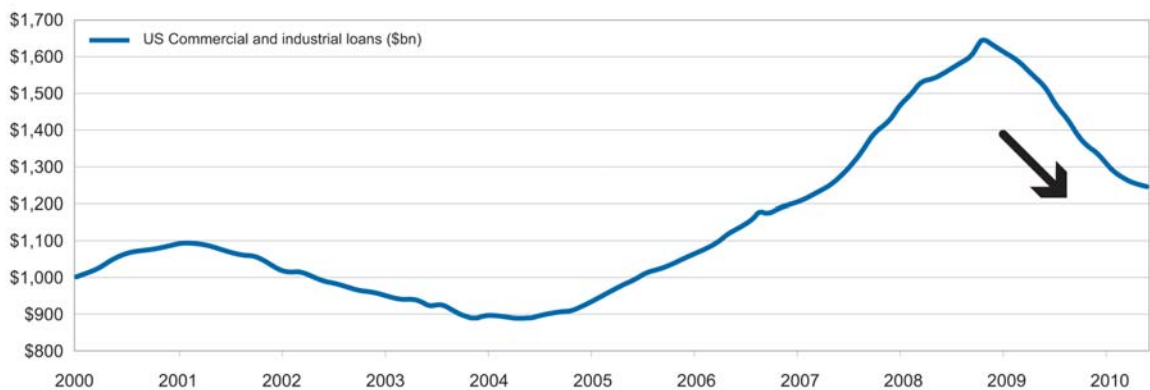
We remarked earlier that a deleveraging downturn is quite different from a de-stocking one. What we can now appreciate is that **deleveraging is likely to turn recession into depression**.

For the intellectual debate, this has two, seemingly-divergent implications. First, it surely tells us that, however correct the Keynesian analysis of impending depression may be, the Keynesian *prescription* (of fighting the downturn with yet more debt) is simply impractical – the developed economies' existing levels of indebtedness surely rule the notion of undertaking yet more borrowing wholly out-of-court.

Second, however, an analysis of the borrowing binge surely destroys any vestiges of credibility still attaching to the *laissez-faire*, de-regulated free market system variously known as 'the Anglo-American model' or 'the Washington consensus'. If the Keynesian prescription is unworkable, **the post-Keynesian system of unfettered markets is a busted flush**. This surely stacks up to an intellectual and policy vacuum where future alternatives are concerned.

Alone amongst Joshua Brown's "Econ Gangs", the "new normalers" are surely the group working along the appropriate lines, though our analysis suggests that their thinking needs to go much, much further.

Fig. 10: Unravelling? US commercial debt, 2000-09*



*Source: Federal Reserve Bank of St Louis

* Source: Federal Reserve Bank of St Louis

If we accept, as we surely must, that debt amounts to consuming now and paying later, we can only conclude that 'later' has now arrived. From this, various conclusions follow:

- First, **there seems to be no way out of the current situation that does not involve economic hardship, perhaps on a deep and protracted scale.**
- Second, **a system that combines excessive consumption with mortgaging of the future simply doesn't work** – and historians of the future are likely to be amazed that anyone ever actually thought that it could.

From an intellectual perspective, we remain convinced that free markets are the best system for the generation of wealth. One only has to look at Soviet Russia, at China before reform, or at present-day economic paragons such as North Korea and Burma, to appreciate that state-controlled economies are recipes for disaster.

But, by the same token, pushing the free market principle too far – to the point of *unfettered* free markets – has created a wealth-destroying equation based on short-termism, greed and irresponsibility. We suspect that free markets work best when their operation is constrained as much by social norms as by regulation. The quest for the "new normal", then, amounts to the challenge of creating a responsible and sustainable version of market capitalism



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