Tullett Prebon Research, a blog by Dr Tim Morgan

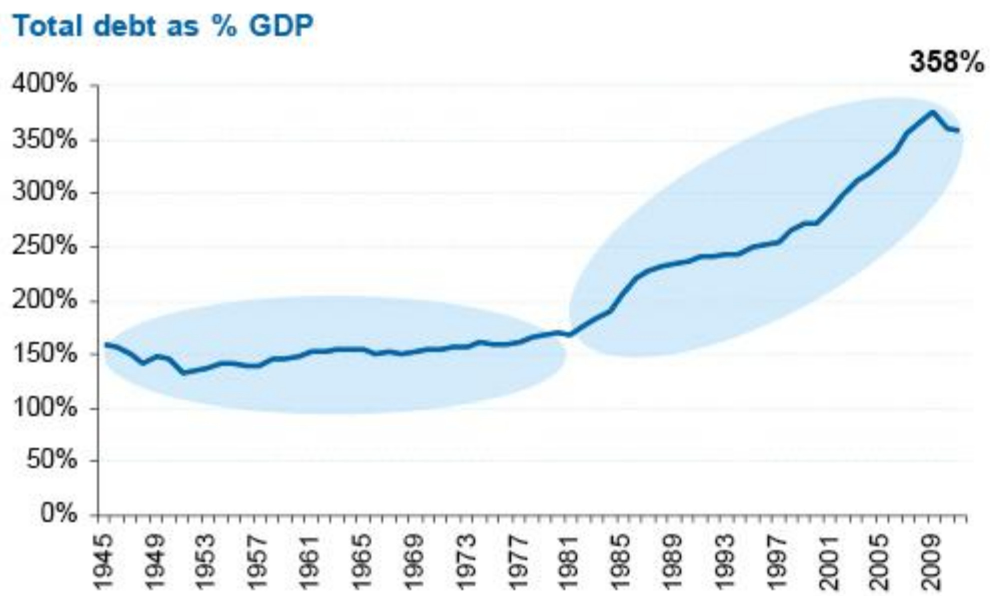
The long-run causes of 'the Great Immoderation'

by Tim Morgan on August 6, 2012

Immediacy is a characteristic of financial markets, and it was Keynes himself who remarked that "in the long run, we're all dead". Despite this, long-run trends do matter. "A society without a history", it has been said, "is like a man without a memory", and is condemned to repeat the same mistakes, over and over again.

Here, then, I'm going to reflect on the long-run trends that created the worst economic crisis for at least eighty years. How on earth did the golden age of the so-called "great moderation" lead us into this?

With hindsight (though many of us knew this long before the crisis), the Great Recession (as I'll call it) was the culmination of three decades of debt-fuelled consumption. The chart below, which shows total American credit market debt in relation to GDP, reveals the sharp upturn which began in the early 1980s. In the four decades after 1945, the debt ratio oscillated in a narrow band between 140% and 170% of GDP. Thereafter, debt grew much more rapidly than income, reaching a peak of almost 360%. This was worse even than the 1930s (when the ratio was pushed upwards by a collapse in GDP). This isn't just about the US, though – it was a pattern replicated throughout much of the western world.



The "great moderation" of the decade before the crash was, in reality, the culminating phase of a "credit super-cycle" in which Western societies became breathtakingly addicted to debt. Worse still, this wasn't investment debt, but was taken on to finance consumption. In some countries (such as Britain), this unaffordable consumption included current spending by the state as well as by individuals.

Some blame bankers for this. I've argued before that legislators and regulators were at least as much at fault. Britain had its Big Bang and its "light-touch" regulatory regime, just as

America repealed the tried-and-tested Glass-Steagall banking separation rules.
Even so, I think that we need to look beyond purely institutional causes. After all, there was a disastrous bubble in Japan in the 1980s even though most of the safeguards that reformers advocate today (such as banking separation) were in place. The fact that, despite these safeguards, the Imperial Palace in Tokyo briefly became worth more (on paper) than the entire State of California surely tells us that something behavioural was happening.

We might conclude from this that no power on earth will prevent people, collectively, from behaving stupidly if they are sufficiently determined to do so. This is a lesson of bubbles down the ages, all of which look idiotic when we look at them afterwards (think Dutch tulip bulbs here, and British South Sea stock).

One difference this time, though, is that we've had *sequential bubbles*, in which people have lurched from one craze into another without any pause for reflection (or counting their losses) in between.
This seems to suggest that bubble mania, previously a once-in-a-generation aberration, has somehow become an entrenched state of mind. This interpretation seems reinforced by the findings set out by Oliver James in his seminal book about 'Affluenza', which looks at consequences of the stimulation of artificial 'needs' in consumers.

It's been easy for some to ridicule the view, set out in a new book by Lord Skidelsky and his son Edward, that there may be more to life than growth and consumption, but my hunch is that they might be on to something. The Skidelskys aside, the main advocates of a less materialist viewpoint are the organised religions, but their promotional firepower is pretty puny when set against a global corporate advertising spend of close to US$500 billion, spending which pushes a message of "you are what you buy".

Whatever the causes, the "Great Immoderation" has run the West into a debt noose that we might not escape for at least a decade. Indeed, if – as I further suspect – the basic energy dynamic is unwinding rapidly, we might never again (or, at least, not for many decades to come) repeat the consumption excesses of the last three decades.

I'm not altogether sure that that's entirely a bad thing, but it certainly suggests that we're entering a wholly new era.