Can I borrow from myself? Of course not. Further, I cannot have too much debt to myself. My future spending plans cannot be constrained by any obligations to make payments at later dates, since those payments will be to me myself.

Similarly, the world cannot borrow from itself and the world economy cannot be overindebted to itself. In the absence of financial transactions with Mars and Venus, the claim that “the world economy has too much debt” is a misunderstanding. The growth of demand in 2011, 2012 and later cannot be held back by allegedly excessive “global debt”.

These remarks are surely obvious. Nevertheless, a common argument since the meltdown is that an overhang of excessive debt will hold back spending and lead to a prolonged period of weak demand. One of the most articulate exponents of this view has been Mohamed el-Erian of the Pacific Investment Management Company. He predicts a long “new normal” period of slow growth, as consumers pay off loans, companies reduce their leverage and governments trim deficits.

Two fallacies are at work here. First, the new normal thesis overlooks the fact that every debtor must be matched by a creditor. Any reduction in spending by net borrowers can be offset by an increase in spending by net lenders.

Second, contrary to media stereotyping, most borrowing is not for the purposes of consumption or even investment in newly-built or soon-to-be-built structures. The greater part of borrowing by individuals is to buy existing houses, while most by companies is to acquire capital assets that are already complete and may have been traded several times. The el-Erian thesis rests on the assumption that lending and spending are related. This is just not so.

More concisely, debts are always matched by identical financial assets, and the cancellation of loans and borrowings arises largely in the course of asset transactions. No inevitable relationship holds between large debt repayments and weak aggregate demand. The private sector may repay debts rapidly and yet the economy can still be booming.

The el-Erian propositions raise the question: “What is the correct theory of national income determination?” The doctrine of the new normal depends on a theory prominent in late 2008 and early 2009, which is now—mercifully—being heard less often. The theory is that lending determines spending and could be called “creditism”. It has its roots in papers written by Ben Bernanke, the Federal Reserve Chairman, and other US economists in the 1980s and 1990s.

Creditism is false and dangerous. The correct theory is that national income is determined by the quantity of money. This means the deposit liabilities of the banking system, since most payments are across bank accounts. The cause of the Great Recession of 2008–09 was not that “the world economy had too much debt” but that in all the leading economies money growth was too high in 2006 and early 2007, but then plunged in 2008 and 2009 to the lowest levels since the 1930s.

At any time, governments and central banks can easily expand the quantity of money. In extremis, they can resort to the printing press. More prosaically, they can borrow from the commercial banks and use the balances thereby created to purchase assets from the private sector, boosting the level of bank deposits. In the last year or two, this been called “quantitative easing”, but Keynes wrote about and explained the operations 80 years ago in his Treatise on Money. The plunge in money growth has now been halted, asset prices are recovering and debts are becoming more manageable. A fairly standard recovery is under way.

Indeed, expansionary monetary policy—in which QE is proving a vital technique—can ensure that 2011 and 2012 are good years for world economies, despite el-Erian’s worries about a debt overhang. Also misplaced are concerns in the commentariat that fiscal retrenchment, stopping the growth of public debt, will prove deflationary. Numerous episodes can be cited—from both our own experience and that of other countries—in which cuts in public spending have been outweighed by larger increases in private expenditure.

Since QE is available as a reserve weapon to boost the economy, the Chancellor of the Exchequer George Osborne must be congratulated on the large, necessary and overdue reductions in government expenditure announced in his Spending Review. All being well, the UK cyclical recovery of 2011 to 2014 will be rather like that of 1982 to 1986 or 1993 to 1997, and very much an example of “the old normal”.

Tim Congdon
‘George Osborne must be congratulated on his large, necessary and overdue reductions in government expenditure’