WORLD KNOWLEDGE FORUM

Richard Koo's Balance Sheet Recession

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On October 21, 2015 at the 16th Annual World Knowledge Forum, Richard Koo, Chief Economist at the Nomura Research Institute in Japan, expanded upon his Balance Sheet Recession theory and explained the difficulty of implementing its practices in times of economic downturn.

According to the balance sheet recession theory, the cause of the global economic crisis was the imbalance of spending and borrowing in the private sector. Mr. Koo illustrated that in any economy, the monetary base, money supply, and loan rates typically move together in close relation. However, after the bubble burst, that all changed instantly.

“When the Lehman shock hit, that relationship broke down completely,” he said.

When the stock market crashed in 2008, global economies were unable to quickly recover because their economic structures shifted almost completely.

“During the bubble, the private sector goes crazy,” Mr. Koo said, as he described their massive borrowing behaviors in the investment of assets. “When the bubble bursts, asset prices collapse, liabilities remain and you realize your balance sheets are underwater. Many of them now are actually bankrupt.”

He assured that the principles of the balance sheet recession theory would, in fact, help stimulate economies, as long as companies decide to pay down debt at zero percent interest rates. Japan experienced a similar financial crash 15 years prior and its corporate deleveraging with zero interest rates lasted for over ten years. However, Japan’s GDP grew despite major loss of wealth, and private sector deleveraging fell 87 percent nationwide.

The solution: keep the corporate balance sheet clean.

Mr. Koo commended the Chinese economy on their efforts to turn around the effects of the crisis.

“I’m happy to report to you, that China understood the concept of balance sheet recession before everyone else,” he said.

In November 2008, the Chinese government implemented a four trillion renminbi fiscal package with a sustained eight percent growth rate. He added that the balance sheet recession approach prevents countries from falling off the ‘fiscal cliff’ which, unfortunately, was not what the European economy did. Hence, the state of their economy as we know it.

“Government borrowing is not large enough to stabilize European countries…that’s the fundamental problem of the European economy,” he said. Housing market crashes across Europe in Germany, Spain, Ireland, Portugal, Italy and Greece exhibited similar, yet negative consequences of massive borrowing during their economic bubbles.

“This is a balance sheet issue, not a structural issue,” concluded Mr. Koo. Applying balance sheet recession demonstrated favorable results in China but “this is very difficult to do in a democracy.”

Nevertheless, the United States is beginning to become more comfortable with taking out credit loans since the crash.

“Does this mean that the U.S. is out of the woods?” Mr. Koo asked. “Unfortunately, not yet…QE is the unwanted child of the balance sheet recession.” QE stands for quantitative easing, a policy implemented by central banks as a means of stimulating the economy when monetary policy has become ineffective.

The U.S. implemented QE to avoid credit explosions but Mr. Koo expressed his concerns for the QE trap. “QE is easy on the way in, but very difficult on the way out,” he warned. This reserve portfolio rebalancing effect actually causes instability in economies. To explain the slowing of the Chinese economy is to examine the effect of QE.

“Everyone blames China,” Mr. Koo said. “In fact, the Chinese market is quite closed. For the relatively closed market to affect the New York Dow one thousand points in a day? That not possible, even God cannot do that.”

Mr. Koo concluded the session by stating that the private sector is very important in leading the stabilization of the economy. “If you take strong enough actions…we can come out of these recessions quickly.”