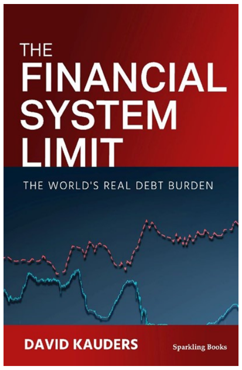
The Financial System Limit

The world's real debt burden



Why were economies sluggish before the pandemic? Why have interest rates paid by businesses and households been rising even though deposit rates are nil? Does the policy of bailing out economies bring any dangers? British investment manager David Kauders FRSA puts forward three radical theories

By David Kauders

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David Kauders FRSA was educated at Latymer Upper School, Jesus College, Cambridge and Cranfield School of Management. He is an investment manager and author.

About the book

Can the world really continue to stimulate its way out of every downturn? What happens to debt as central banks and governments buy prosperity?

In **The Financial System Limit,** the author puts forward three radical theories which show that Keynesian economics can no longer benefit society. He explains why debt cannot expand to infinity; then how debt interest is a cost to us all. The global economic cycle is now determined by central bank policies.

David Kauders FRSA is a British investment manager who has been concerned about the hidden social costs of easy money. This is his third book.

Read The Financial System Limit to understand why banks keep failing and learn why financial and economic policies have to change. You will discover why debt reduction programs do not work and what will follow the recent inflation.

Instead of reacting to the news stories of the day, join the challenge to the economic consensus by reading The Financial System Limit.

Reviews

"One of the most fascinating books I've ever read ... I am recommending this book, and will. It is a must in one's library and to be transmitted to next generations."- *Flo Jacquet, Teacher, France*

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"The author provides a historical view of how we reached the point where the level of global debt is unsustainable and now compounded by a global pandemic. The book is understandable by those without a deep financial background.

“Kauders, who has decades of experience as an investment manager makes the case for the difficult situation we, as global citizens, are confronted with.”- *Librarything reviewer*

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“A very good book about the financial system. How debt works. How debt works and has worked for and against various countries at various times. Highly recommended!” - *Hal Perlman, USA*

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“The book pleas to measure interest cost on total debt in relation to economic output. A deep recession and consequential financial upset were inevitable in a world that could not resolve the conflict between stimulus and austerity, a world that remained addicted to debt, a world that refused to admit the limit to the growth of debt caused by the cost of servicing it. That’s what David Kauders wants to highlight.”- *Henk van der Klis, Netherlands*

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“Credit to Kauders for sharing his observations, experience and proposing solutions.”- *Librarything reviewer*

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“This book by David Kauders provides some unique and interesting insights on macroeconomics and money in general. The topic of debt is such a complex and loaded topic but Kauders approaches it in an easy to understand manner (you don’t have to have an economics background). This book is a not a light read or an easy read but its worth the read.” - *Reviewer, Canada*

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“The book starts with a “Definitions and Explanations” section, which is helpful in clarifying some terms and concepts...

“One of the author’s main points seems to be that credit can not be created forever, because there reaches a point at which the debt level of a society makes repayment of the debt impossible. Kauders discusses this and other ideas, including the economic strategies of governments to deal with the pandemic, the true cost of debt, and economic cycles cause by central banking policies. His ideas about modern monetary theory and pensions are interesting.”- *Review posted on amazon.com*

Excerpt

When someone borrows money to put food on the table, they are in financial difficulty. When they have no hope of even paying the mounting interest bill, let alone repaying their debt, they are bust. This can also happen to a country, when so many people are in financial difficulty that there is no hope of the indebted population honouring its debts even if some people within it are debt-free. In this situation the said country has reached its financial system limit. Neither action by the individual, nor policy change by the authorities, can work off the debt because too much is being spent on paying interest. The underlying problem will manifest itself in many ways: curtailed business activity; inability of consumers to keep spending; falling prices of assets that were propped up by easy credit; almost continual recession with only brief flashes of recovery. The financial system limit of any society is the debt level at which repayment ceases to be viable.

It is customary for economic statisticians to define highly indebted countries according to their government debt levels. However, for the purposes of this book, it is *total* debt that matters. Total debt is the sum of government debt, corporate plus banking system debt and personal debt. Personal debt itself consists of overdrafts, bank loans, mortgages and credit card debt.

Of the 36 current members of the Organisation for Economic Co-operation and Development (OECD), 28 feature in a list of countries having high levels of personal debt. Personal debt is a developed-country problem. Prosperity has been bought, literally, on credit...

Over the past quarter of a century, rates paid to depositors have collapsed, yet rates paid by borrowers have stayed comparatively high. Comparing paid and earned interest rates reveals how expensive credit is. From 1993 to 2001, the difference between three-month US Treasury Bill rates (a proxy for interest paid to depositors) and the average cost of US credit card debt including financing charges was around 9%. In 2003, in the wake of the dot com crash, deposit rates hit new lows, with Treasury Bills only paying 0.81%. But at the same time, credit-card borrowers were paying around 14.7% on average, so the difference had risen to 13.9%. The credit crunch subsequently drove Treasury Bills down to nil yield but a few months later credit card rates were climbing, with the difference, as at December 2019, at around 15.4%.

Debt repayment has a real cost because inflation is so low. When real interest rates are positive and rates paid by borrowers exceed the inflation rate, borrowing consumes financial resources. For example, when inflation is 1% and credit-card borrowing costs 13%, the real rate of interest is 12%. Prior to the era of monetary management by central banks, real interest rates were usually 2% to 3%.

Symptoms of debt problems caused by excessive interest costs vary by country. In many cases, they can be measured directly by statistics such as consumer loan defaults. In Britain, food bank use is an indirect measure of debt problems.

Following the 1987 stock market crash, the credit floodgates were opened wide to encourage more borrowing. When continuing that policy proved ineffective after the millennium boom and bust, quantitative easing was invented to push credit into the Japanese economy. This was later copied by other central banks although the methodology is now seen as ineffective. Instead of contriving ever more extreme measures to expand credit, why not ask what is preventing continued economic growth?

It is impossible for debt to expand to infinity because the cost of servicing it would then also be infinite. The financial system limit is determined by the cost of borrowing. It is best defined as the proportion of economic output spent on interest on total debt, above which that debt can no longer be repaid in full...

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Existence of the financial system limit can be proved by logic:

1. Postulate that it does not exist and therefore debt can expand to infinity.

2. No matter how low interest rates charged to borrowers may go, any percentage of infinity is itself infinity. Therefore if debt can expand to infinity, interest paid must also expand to infinity.

3. Interest has to be defrayed from what is earned. Earnings can only be achieved by selling goods or services at a price others can afford. Therefore paying infinite interest requires trading an infinite

supply of goods and services.

4. But an infinite supply of goods and services for sale can only be achieved if resources of people and nature are themselves infinite.

5. Since the supply of raw materials is finite and an infinite population could not feed itself, the proposition that debt can expand to infinity cannot be true.

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The world is now starting the sixth iteration of the central banking economic cycle:

1. The first of these cycles was the Japanese boom in the late 1980s and subsequent bust, overlapping with the Western escape from the 1987 crash.

2. The second was the Asian boom, followed by the 1997 bust.

3. The third was the millennium boom and dot com bust.

4. The fourth was the 2002 to 2007 boom followed by the credit crunch.

5. Quantitative easing was used to drive recovery from the credit crunch, but this led to economic stagnation.

6. The authorities are now using both quantitative easing and fiscal stimulus in an attempt to neuter the economic effects of the pandemic and start another economic recovery.

Economic cycles always come to an end. The central banking economic cycle will be no exception.

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In the days when the early Italian bankers invented debit and credit, there was no European Commission, Federal government or British regulator to lay down detailed prescriptive rules. Nowadays, politicians announce their demands, then set retinues of bureaucrats to implement their grandiose projects. The bureaucrats write detailed proposals, 'consult' on how the detail will work to ensure a degree of practicality, then write legislation to implement their design.

For alternatives to the present debt-based financial system to emerge, bureaucratic design and excessive standards must be constrained from further growth. Then some other kind of financial system might evolve, rendering the financial system limit less significant. Separation of debit and credit invented by the early Italian bankers has reached the end of its useful life. The challenge is to maintain the protections of the present system while providing an environment that encourages alternatives...

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Authors who drive ideas forward are often expected to propose next steps, or perhaps prescribe what should be done. There are no easy answers to the problem of deflation caused by excessive levels of debt. The priority should be to stop making the situation worse...

While I was writing the first draft of this chapter, *The Economist* published an article exploring current economic theories about debt. The theory that government debt crowds out productive debt featured in it, as did Modern Monetary Theory.

But what exactly qualifies as productive debt? And why is government debt not productive? These are meaningless diversions. Total world debt is what matters but the aggregate cost of interest and its relation to economic output was not even mentioned. Neither was the inability to expand debt to infinity, nor existence of a central banking economic cycle.

The *Financial Times* then published an opinion article that correctly noted the ratio of total world debt to economic output but also omitted to identify the same issues. The author thought that transparency would be the key to controlling debt. Instead of describing the wrong kind of debt, an approach this book rejected in Chapter 7, the article suggested that the world's debt problems arise from the wrong way of looking at debt. This book proposes that the right way of looking at it is to measure interest cost on total debt in relation to economic output.

The coronavirus pandemic will be seized on by the commentariat as the 'cause' of this economic crisis and conveniently scapegoated by politicians. The truth is that a deep recession and consequential financial upset was inevitable in a world that could not resolve the conflict between stimulus and austerity, a world that remained addicted to debt, a world that refused to admit the limit to the growth of debt caused by the cost of servicing it.

The central banking economic cycle is a crucial element in this depression. Every crisis—think of the dot-com bust and credit crunch as well as coronavirus—results in panic measures to extend economic stimulus. These measures inevitably add to the debt burden and the deflationary forces in the global economy, thereby bringing the financial system limit closer.

The debt-based financial system as we know it has run its course. The whole world is now over half-way to default. Whatever replacement to debt emerges, the world must ask: do we wish to compound economic and political upsets by continuing to expand the supply of credit? Are short-term benefits worth the longer-term cost?

I have long subscribed to the view that the policy of constantly borrowing from the future would ultimately prove unsustainable and therefore some sort of debt reckoning would lie ahead. By throwing the entire world into deep recession, the coronavirus pandemic has brought the prospect of serious deflation closer.

Much deeper issues about the sort of society we wish to be will undoubtedly come into focus in the next few years. The very existence of the financial system limit needs to be part of such thinking. Academia has apparently failed to see how serious the debt problem is, instead producing irrelevant theories that miss the severity of the debt pile. Do we have to wait for most of the world to face Puerto Rican debt conditions before anyone notices?

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