

Koo, Richard C.- The Holy Grail of Macroeconomics

John Wiley & Sons, 2009, [Economics] Grade ★★★★★

In the end, an economic theory is just as good as its basic assumptions. One of the core assumptions for almost all Economists is the belief that all corporations always try to maximize profits. Is that assumption always valid? No, argues Richard C. Koo, Nomura's Chief Economist. A few times during a century, after a major asset bubble breaks, corporations change focus to debt minimization. It creates a huge impact on the economy and needed policy actions. This was the catalyst to The Great Depression and to the recent Japanese recession, according to Koo. He doesn't hesitate to debate Bernanke, Keynes, Friedman, Krugman and others on this issue. Time will still tell who is right, but Koo's case is extremely convincing. Even a long-term bottom-up value investor will find new use for macroeconomics with his arguments.

A balance sheet recession is a vicious circle. When an asset bubble breaks because of Monetary tightening, management are forced to save their insolvent companies by allocating all cash flow to debt repayment, independent of the borrowing rate. Few see it initially because it is not in management's or bank's interest to speak about it, and it's usually hard to detect in aggregated numbers. During the Japanese recession, GDP growth was still doing fairly well and the annual deflation was never more than roughly 1 percent.

Koo's innovation is a division of the state of the economy in two main phases: (1) The "normal" Yang (light) phase where the private sector is healthy, maximizing profits and where monetary actions from Central Banks are highly effective and (2) The Yin (shadow) phase where corporations struggle to repay debt, the demand for funds are essentially non-existent, and "*the economy heads towards a contractionary equilibrium known as a depression.*" In this phase, governments need to do the opposite of the private sector - they must borrow and spend. This is all about aggressive fiscal policy. Deficits and high public debt levels

are of secondary importance. In a Eurozone balance sheet recession, the Maastricht 3% cap will be a devastating constraint. Koo's Yin-Yang cycle of bubbles and balance sheet recessions is a true intellectual advance!

Koo also examines several other – even the more spectacular - suggested policy actions in the public debate including helicopter money, government purchases of bonds, capital injections in banks, etc. His conclusions are very value added.

Is Koo's Balance Sheet Recession Theory just a modernized update to Irving Fisher's Debt Deflation Theory? No, but there are similarities. "Debt Deflation" begins with a rapid fall in output prices whereas a "Balance Sheet Recession" starts with a major fall in asset prices, which is more common.

Are we in a Balance Sheet Recession currently? "*The subprime fiasco contains certain peculiarities that are not found in the past balance sheet recessions. For one, the problem originates with the household and banking sectors, rather than the corporate sector.*" But the story doesn't stop there. There are many commonalities with the situation in Japan during the last 20 years. Chapter 7, "Ongoing Bubbles and Balance Sheet Recessions," was an exciting page-turner for me. That goes for the update in Chapter 8 too (I read the revised edition from 2009).

This book has really opened my eyes in many ways. Koo's explanation for the different phases in his Yin-Yang circle is very logical and well written. Suddenly, it all fits together. And the crucial question regarding reflation/deflation in this secular trend is much easier to analyze. Without doubt, this will be a classic. Kudos for extremely useful graphs and tables. One minor nuisance is the extensive repetition of some of Koo's more important arguments. This book is a high IRR investment for all market participants.

Michael Persson, May 23, 2012