THE ROAD TO RECOVERY
THE ROAD TO RECOVERY
How and Why Economic Policy Must Change
ANDREW SMITHERS

WILEY
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For Jilly, with love and admiration
Foreword

by Martin Wolf

Andrew Smithers is a truly remarkable man. He brings to his analysis of the economy and financial markets a combination of abilities that is, in my experience, unique. Notable in this list are intelligence, eclecticism, pragmatism and independence. Andrew is devoted to the facts, is never impressed by status and possesses both deep knowledge of financial markets and a penetrating understanding of economics. Above all, he has an apparently uncanny — indeed, downright infuriating — tendency to be right.

Yet, in truth, his tendency to be right is not uncanny at all. Andrew is so often right not just because he has great intellectual abilities but because he cares about being right. His record is a triumph of character. He has the abilities of a first-rate academic. But he has never been one. He is, as a result, liberated from what he justly condemns as the “scholasticism” of academic economics.

When I look back on my many discussions with Andrew over the last quarter of a century, I find myself reminded of Bertrand Russell’s remark that “Every time I argued with Keynes, I felt that I took my life in my hands and I seldom emerged without feeling something of a fool.” I feel the same way about debates with Andrew. But however foolish Andrew may frequently have made me feel, I know how much I have benefitted from his insights. Alas, I would have gained even more if I had paid his views even more attention than I did.

I first became aware of Andrew’s exceptional qualities when I met him in Tokyo in the late 1980s, where he was then working
for the late lamented S. G. Warburg. I learnt much from him at that time about what was happening in the Japanese corporate sector and particularly about the implications of the extensive crossholdings of shares.

Yet Andrew’s analysis first transformed the way I thought in the mid-1990s. It was then that I read his work for Smithers & Co., his recently founded research house, on the correct way to value stock markets and the emerging bubble in US stocks. I found this analysis both brilliant and persuasive. It influenced my writing on the stock market throughout the decade. The fruit of this work was subsequently published for a wider public in March 2000, perfectly timed for the market peak, as Valuing Wall Street: Protecting wealth in turbulent markets, co-authored with Stephen Wright of Cambridge University.

Andrew’s introduction of “Tobin’s Q” (the ratio of the market value of equity to the replacement value of corporate net assets) into the valuation of stock markets was a profoundly important idea. It was a theoretically better-grounded complement to Robert Shiller’s cyclically adjusted price earnings ratio. To me, the idea was an eye-opener. It would have been an eye-opener to the rest of the world, too, if more people had been willing to pay attention. But it is hard to persuade people to change their minds if their salaries depend on remaining un-persuaded.

In making this point, too, Andrew introduced me to the idea of “stockbroker economics”. That is the art proving that assets are always cheap, however expensive they may actually be. But the purpose of stockbroker economics is, he noted, not wisdom, but sales. In the 1990s stockbroker economics needed to show extraordinary imagination, as stock prices soared, on occasion even suggesting that no equity risk premium was needed.

A particularly significant contribution of Valuing Wall Street was the book’s demonstration that the efficient market hypothesis does not hold for the stock market as a whole, even though it does hold for the relative values of individual stocks. The stock market does not follow a random walk, but shows serial correlation, instead. In other words, markets show trends. Sometimes they become increasingly overvalued. At other times they become increasingly undervalued. Such bubbles can persist, partly because the cost of betting against long-term market overvaluation is prohibitively high. In the
case of housing markets, it is effectively impossible to bet against overvaluation.

This argument demonstrated that, contrary to the conventional wisdom of economists, it was not only possible for markets to enter bubble territory but also possible to know when they were doing so. Andrew’s conclusion was that central bankers were profoundly mistaken in refusing to identify and prick bubbles, relying on cleaning up the mess afterwards instead. In Stock Markets and Central Bankers: The economic consequences of Alan Greenspan, which was published in 2002, Andrew argued that the policy of doing everything to avoid recessions was a big mistake, partly because it created asset price bubbles. On the contrary, he argued, the only way to avoid the occasional huge recession was to accept frequent small ones.

I was not fully convinced of this proposition in the early 2000s. But subsequent events have, yet again, proved Andrew right and the world’s central bankers (and me) wrong.

Andrew’s ability to be both out of the mainstream and right (the former being, almost certainly, a necessary condition for the latter) was shown in smaller matters as well as such big ones. Throughout the 2000s, Andrew argued that UK fiscal policy was far too loose. On this, once again, he has been proved right. Along with that argument went the view that the UK and US were saving and investing too little, a failing that was masked by their (temporary) ability to run large current account deficits and so import capital-intensive manufactures. This argument, too, looks increasingly relevant and persuasive.

Readers should approach the present book, which Andrew has suggested may be his last, with this remarkable history in mind. Most will find its arguments uncomfortable. But they will also find them trenchant, original and brilliant. Above all, if history is a guide, they are likely to be proved largely correct.

The book’s most original argument is that the “bonus culture” is creating a far bigger economic disaster in the US and UK than almost anybody has realised. Because leveraged options on the share price are such a large portion of their compensation, managers run their businesses not for long-term profit but for short-term return on equity. They achieve the desired outcome by buying back shares, so shrinking their equity base, and raising prices, so boosting profit
margins. As a result, companies both over-save and under-invest. In essence, managers are rewarded for extracting short-term rents, while running their companies into the ground. One consequence is that US and UK businesses are becoming more leveraged, not less, as many assume.

This development, argues the book, puts governments in a dreadful dilemma. Without continued huge fiscal deficits, demand is likely to collapse. But these fiscal deficits may have to continue indefinitely. That threatens to rekindle dangerous expectations of high inflation. The problem, then, is that deficient private sector demand is structural, not merely cyclical. Policymakers consequently find themselves navigating between the Scylla of inflation and the Charybdis of depression.

To realise how Andrew reaches these and other disturbing conclusions, one needs to understand his starting point. His views on what has gone wrong in economies emerge from his ideas on what has gone wrong with economics. He states that the two major deficiencies of modern academic economics, a reliance on mathematical models which are sometimes untestable, and an insufficient attention to data, have become major obstacles to the introduction of sound policies. Overreliance on elegant models and indifference to data on how economies work are, in Andrew’s view, fundamental to everything that has gone – and continues to go – wrong.

More broadly, the book focuses on six challenges.

First, it argues that the excessive level of debt needs to be brought down. Over time the tax treatment of debt must be changed, since it encourages companies to have dangerously high leverage.

Second, while the build-up of debt creates conditions for financial trouble, it requires a trigger to set off actual crises. That trigger is usually a fall in asset prices. Policymakers need to devote far more attention to the valuation of assets. In addition, argues the book, “quantitative easing” encourages the overvaluation of assets and so should be slowly reversed.

Third, the fiscal deficits of Japan, the UK and the US must be brought down without creating another recession. This requires that greater attention be given to the counterparts of these deficits, which are the cash surpluses being run by businesses and by other countries. What are needed therefore are reductions in fiscal deficits in Japan, the UK and the US, which are offset by rises in fiscal
deficits in the rest of the world. Above all, there must be a rebalancing of the global pattern of current account deficits and surpluses.

Fourth, the reason fiscal deficits are likely to be needed is that the business sectors of Japan, the UK and the US now run cash surpluses that will not disappear without big changes in policy.

Fifth, banking is still a mess. Major reforms are needed to reduce the risks that the industry runs and to ensure that it becomes properly competitive. Among those reforms must include much higher equity and a complete separation of market making from retail banking.

Finally, argues the book, the need for better economic understanding is not only limited to Keynesians and monetarists. It is ever more needed among the anti-Keynesians, whose policies seem to rule the eurozone.

In addressing these six challenges, Andrew provides thought-provoking analyses of the consequences of corporate incentives. He analyses the mistakes of central banks in the run-up to the crisis. He discusses the fragility of banking. He looks closely at the excesses of leverage. He justifies the Keynesian response to the crisis, but argues that the wrong countries have, yet again, chosen to go in this direction. Meanwhile, Germany’s failure to understand the need for higher demand is undermining the ability of the eurozone to escape from its economic mire.

In all, the book is a characteristic delight: wide-ranging, full of fascinating information, provocative and dismissive of those whom its author views as incompetent. Intellectually, Andrew takes no prisoners. Readers will often want to disagree. I myself am unpersuaded on a number of important points: I am not convinced that large fiscal deficits bring imminent risks of higher inflation or higher inflation expectations; I am not persuaded that quantitative easing is dangerous in the current circumstances; and, again, I am far from sure it will be possible to eliminate the bonus culture, even if it is as damaging as Andrew argues.

Yet, even when I disagree, I remember an important lesson of my experience: I am almost certainly going to be proved wrong.

This book is a feast. Enjoy the spicy food it provides.

Martin Wolf, Chief Economics Commentator, Financial Times
Introduction

The world economy is badly managed and thus doing badly. The financial crisis caused the most severe recession since the depression of the 1930s. The fall in output has been arrested but the recovery has been disappointing. If neither the crisis nor the weak rebound were inevitable, we must be suffering from policy mistakes. Either economic theory is sound but being badly applied or it contains serious weaknesses. In this book I will seek to explain what has gone wrong and the steps needed to put the world economy back on track for a sustained recovery.

The errors of policy have their sources both from failures to understand and apply the parts of economic theory which are sound and from failures in the generally accepted theory, which policymakers have sought to follow. The economic policies of the eurozone fall into the first category. For the zone as a whole, short-term fiscal policy should be aimed at expanding rather than contracting deficits, and my view is probably shared by a majority of economists. But there are two areas where, I think, theory has failed. The first lies in misunderstanding the causes of the crisis and thus the policies needed to prevent its repetition. The second is the failure to recognise, and thus be able to remove, the obstacles that currently prevent sustained recovery in Japan, the UK and the US.
With regard to the crisis, there are many issues over which the views of economists diverge, and many of the points I will be making are shared by others. At the moment, however, I seem to be more or less alone in my identification of the problems currently impeding recovery, a situation which I hope this book will change. If I am correct, the vast bulk of the current debate on economic policy is misdirected and new policies are needed to produce a more satisfactory recovery in terms of both its speed and its sustainability.

I aim to convince the reader that the financial crisis, the great recession which it produced and the failure to generate a strong recovery are all the results of policy errors in the management of the economy, and I will rely heavily on data in my task of persuasion. I will use many charts because these are often the easiest way to communicate the data’s messages. They will also provide pictures as I am mindful of Alice’s comment, when looking at her elder sister’s book and about to nod off to sleep to dream of Wonderland. “What is the use of a book,” she remarks, “without pictures or conversations?”¹ Even in the form of quotations, I have been able to include only a limited amount of conversation, but to compensate for this and console readers for its absence, they will find plenty of pictures.

¹ From Chapter 1 of Alice’s Adventures in Wonderland by Lewis Carroll.
Why the Recovery Has Been So Weak

We are now suffering from a weak and halting recovery. Chart 1 shows that among G5 countries only in Germany and the US has real GDP risen above the level that was achieved in the first quarter of 2008. Both the UK and the US provide examples of how unusual the recession has been, both in terms of the slowness of the recoveries and in the depths of the downturns. It has taken longer to recover to the previous peak in real GDP than on any previous occasion since World War II. Indeed, there are claims that the UK recovered more quickly in the 1930s than it has after the recent recession.1 The US took four years from Q4 2007 to Q4 2011 to recover to its previous peak and the UK after four and half years has still not recovered to its Q1 2008 peak. In both countries the loss of output from peak to trough was the greatest seen in the post-war period, amounting to 6.3% of GDP for the UK and 4.7% for the US.2

1“A funny way of firing up the locomotive” by Sam Brittan, Financial Times (17th January, 2013).
2The worst previous post-war recessions were during the first (c.1973–1976) and second oil shocks (c.1979–1983); neither their length nor their duration was as severe in either country as the post-shock recessions.
The weak recovery has occurred despite the most aggressive attempt at stimulating the economy, in terms of both fiscal and monetary policy, that has been tried since World War II.

Interest rates were kept low in wartime, but then rose and have now fallen back to their lowest post-war level in nominal terms (Chart 2).

The pattern is similar, though more nuanced and less marked in real terms. Chart 3 shows that for both the UK and the US interest rates were very low in real terms after the war and after the oil shock, owing to high rates of inflation. With these exceptions, current real interest rates and bond yields are at their lowest post-war levels.

Chart 4 shows that the pattern was the same for other G5 countries. Both real and nominal rates are exceptionally low and the fall in real rates is only constrained by the relatively low levels of inflation.

As Chart 5 and Chart 6 illustrate, the Japanese, UK and US governments’ deficits have all risen to over 10% of GDP in recent years, while Germany’s budget is currently balanced. France’s deficit

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**Chart 1.** The Weak Recovery of G5 Countries.  
Sources: National Accounts via Ecowin.
Chart 2. US: Interest Rates & Bond Yields.
Sources: Federal Reserve & Reuters via Ecowin.

Chart 3. US: Real Interest Rates & Bond Yields.
Sources: Federal Reserve, Reuters & BLS via Ecowin.

Why the Recovery Has Been So Weak

7.6% of GDP and is thought to have fallen to 4.5% of GDP in 2012.

Large deficits have not therefore been successful in generating strong recovery. Nor has the growth of individual economies been associated with the size of their deficits. Japan, which has the largest current deficit, shares with the UK the wooden spoon for recovery, and Germany with no deficit has achieved the best recovery alongside the US.

Neither fiscal nor monetary policy has therefore been successful in creating the growth rates that are generally assumed to be possible. It follows that either the growth potential is less than assumed, the policies are correct but have not been pursued with sufficient vigour or the policies are ill considered.

My view is that the policies have been the wrong ones and, although I am not alone in thinking this, my reasons seem very different from those of other economists who share my conclusion. At the centre of the disagreement that I have with those who favour more stimulus is why the economy remains weak. The central issue is whether it is due to short-term, temporary problems, which are

Source: OECD via Ecowin.
termed cyclical by economists, or structural ones which last longer and tend to be more intractable. The key difference between my views and the proponents of more stimuli is that I see today’s problems as structural which need to be addressed with different policies, while those who favour continuing the current medicine but upping the dosage assume that the problems are purely cyclical.

On the other hand I do not agree with those who see the structural problem as being a lack of output capacity. This in my view is overly pessimistic. There seems to be plenty of unused capacity in terms of both labour and capital equipment; the problem is that there are structural inhibitions to this capacity being used, without creating inflation. We are not being held back by either a simple cyclical weakness in demand or a lack of capacity to grow: we have a new structural problem that we have not encountered before.

As I will seek to explain, the key structural inhibition that is preventing the spare capacity which we have in both labour and capital equipment from being fully used is the change in the way company managements behave, and this change has arisen from the change in the way managements are paid. There is abundant evidence that a dramatic change has taken place in the way those that run businesses are paid. Their incentives have been dramatically altered. It should therefore be of no surprise that their behaviour has changed, as this is the usual result of changed incentives.

For the economy as a whole, incomes and expenditure must be equal. No one can spend more than their income unless someone else spends less. If one company, individual or sector of the economy spends more than its income, it must find the balance by selling assets or borrowing from somewhere else, and the company, individual or sector that lends the money or buys the asset must spend less than its income. A cash flow deficit in one sector of an economy must therefore be exactly matched by a cash surplus in another. I am not here making a forecast but pointing to a necessary identity and one which it is essential to understand in order to comprehend the nature of the problem that we face in trying to bring government budget deficits under control.

Although much that is forecast is not very likely, almost anything in economics is possible, subject only to the essential condition that the figures must add up. This is always important, and often neglected
by forecasters, but it is particularly informative when a large reduction in fiscal deficits is essential. This is because any reduction in fiscal deficits must be exactly matched by reductions in the combined cash surpluses of the household, business and foreign sectors. When the deficits fall, the cash surpluses of these other sectors of the economy must fall by an identical amount. The OECD estimates that in 2012 the UK and US economies had government budget deficits, which are also known as fiscal deficits, equal to 6.6% and 8.5% of GDP respectively. To prevent a dangerous and unsustainable situation arising in which the ratios of national debts to GDP are on a permanently rising path, these fiscal deficits must be brought down to about 2% or less of GDP. It follows, as a matter of identity, that the surpluses in the household, business and foreign sectors of the economies must fall by around 4.6% of GDP for the UK and 6.5% for the US from the level estimated by the OECD in 2012.

One of the major lessons of history is that economies must from time to time adjust to large changes and can do so without disaster, provided that the speed at which they are required to adjust is not too rapid. It will therefore be very important to make sure that there are smooth rather than abrupt declines in the fiscal deficit and thus in the matching declines of other sectors’ cash flows. Unfortunately, ensuring that the adjustment is smooth is also likely to be very difficult. This is partly because the economy is unpredictable and partly because political decisions are often wayward. But it is also because the impact is likely to fall mainly on the business sector, and, if the hit is too sharp, companies are likely to respond by reducing investment and employment, thus causing another recession. The probability that a reduction in the fiscal deficit will fall most heavily on the business sector is shown both by past experience and from considering the contributions that are likely from other sectors.

In the past, changes in the fiscal balances of the major Anglophone economies have moved up and down with fluctuations in the business sector’s cash flow, as I illustrate in Chart 7 for the UK and for the US in Chart 8.\(^3\) On historical grounds, therefore, the

\(^3\)The correlation coefficient between business cash flow and the fiscal deficit is 0.71 for the UK and 0.83 for the US. In each case we measure the relationship for the whole period for which we have data, which are annual from 1987 to 2011 for the UK and quarterly from Q1 1960 to Q3 2012 for the US.

scale of the reductions required in the fiscal deficits means that large compensating falls in the cash surplus of the business sectors will be needed.

As Chart 7 and Chart 8 show, companies in both the UK and the US are currently running exceptionally large cash surpluses. It is the existence of these surpluses as well as their size which is unusual. As Table 1 shows, until recently companies have tended to run cash deficits. It is only over the past decade that companies have been producing more cash than they pay out, either to finance their spending on new capital investments or to pay out dividends.

The regular cash deficits shown before 2001 are the expected pattern. The business sector normally finances itself partly from equity and partly from debt. The extent to which companies finance their business by debt compared to equity is called their leverage. If, for example, half of companies’ finance comes from borrowing and the rest from equity, the ratio of debt to equity will be 100%, i.e. debt and equity will have equal values. There are limits to the extent that companies can finance themselves with debt. Their leverage rises as the proportion of finance from debt rises, and as this ratio becomes higher so does the risk that lenders will lose money when the economy falls into recession. This puts a limit on the extent to which companies can finance themselves with debt. Their leverage rises as the proportion of finance from debt rises, and as this ratio becomes higher so does the risk that lenders will lose money when the economy falls into recession. This puts a limit on the extent to which companies can finance themselves with debt, but this limit is not fixed. If lenders don’t find that they are experiencing losses from bad debts, they assume that current leverage ratios are conservative and are willing to lend on the basis of even higher ratios of debt to equity. But this is a dangerous process, because high leverage increases the risks of a financial crisis and the risks that it will cause a deep recession.

Leverage can vary a lot over time, and I will be showing later that business debt had risen to unprecedented heights prior to the financial crisis. It has since fallen a little but remains nearly at record

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levels and it is almost certain that it is still dangerously high. We should therefore wish to see leverage falling and thus see equity providing a higher proportion of companies’ financial requirements than has been the case in recent years.

It is easy to see how the growth of the economy can be financed by a mixture of equity and debt. In a long run stable situation the leverage ratio will also be stable. If debt and equity each provide half the capital needed, this will also be the ratio by which new investment is financed. However, the proportion of new investment that needs to be financed with equity will always be a large one. If, for example, over the long-term, investment is financed 60% by debt and 40% by equity, rather than 50% by each, the leverage rises sharply. In the first example debt will equal 100% of equity and in the second it will be 150%. This measure of leverage would thus be 50 percentage points higher than if the proportions financed by debt and equity had remained equal. In practice things can be more complicated, but the broad outline is nonetheless clear. Over time the capital stock must grow if the economy is to expand and, over the long-term, companies must therefore add to their equity capital at a steady rate. This equity capital is equal to the value of companies’ assets less the amount that they have borrowed to finance them and is also known as net worth.

Equity rises from operations if companies pay out less than 100% of their after-tax profits as dividends and falls if they pay out more. Equity can also be increased by new issues and will fall if companies buy back their own shares or acquire other companies using cash or debt. Companies either run down their cash or increase their debt when they buy back their own shares, and this often occurs when they acquire other companies. It is possible to finance acquisitions with the whole cost being met by equity through companies using their own shares. In recent years companies have been using debt to finance acquisitions of their own and other companies’ shares to a much greater extent than they have been making new equity issues and they have also, of course, been paying dividends. By adding up the sums of money spent on buy-backs, acquisitions and dividends, and deducting any amount raised from new issues, we know the total amount of cash that companies are paying out to shareholders.
As I show in Chart 9, US companies, according to the official data, have in recent years been paying out in cash more than 100% of their domestic profits to shareholders. They probably don't know that they are doing this as the figures they publish as their profits are usually overstated and, as I will show later, amount to more in aggregate than the profits that are shown in the national accounts. Such a high level of cash distribution could last for some time, particularly if inflation were to be rapid, as this would reduce the real value of debt incurred in the past while the real value of companies’ investments in plant and equipment would be unaffected. But rapid inflation is not stable and brings with it the need for a large expansion in working capital, which is one of the reasons that inflation has not in the past been associated with a decline in the ratio of debt to GDP. Indeed, as I will show later, the ratio of debt to GDP has not, between the end World War II and 2008, shown any sign of slowing whether inflation has picked up or fallen back.
Distributing more than 100% of profits to shareholders in cash, through a combination of dividends and buy-backs, which as Chart 9 shows is the current situation, may continue for some time, but it is not a stable situation.

Looking ahead, we can be sure, or at least as sure as anything can be in economics, that the UK and US fiscal deficits must fall and that this must be accompanied by a decline in companies’ cash flow. Such a fall must come either because companies invest more or because they save less. If they invest more, they will need to pay out less money to shareholders in order to prevent their debts rising even faster than they are at the moment. If they don’t increase their capital spending, a decline in their cash flow will mean that their retained profits must fall. Even if they don’t cut their dividends, a fall in retained profits will mean a fall in profits.

When profits fall, companies usually distribute less in dividends, particularly if the fall takes place over several years and is not restricted to a relatively mild and short-term drop. So companies will probably cut dividends if profits decline. Any fall in dividends will increase the extent to which the fall in retained profits is reflected in a fall in total profits. There can be temporary factors that mitigate the speed at which leverage rises and this can defer the speed at which other adjustments have to be made. For example, last year the value of companies’ real estate rose, according to the Flow of Funds Accounts (“Z1”) published by the Federal Reserve. But without such fortuitous help companies must, at the current level of profits, cut back the amount of cash they distribute to shareholders or their leverage ratio will rise. If profits fall, they will have to cut back even more on the amount of cash they spend on dividends and buy-backs.

When governments manage, at last, to cut back on their budget deficits, companies’ cash flow is going to fall. It is most likely that we will return to the usual situation in which a business runs cash deficits rather than surpluses. When this happens there must also be a large fall in the amount of cash that companies distribute to shareholders either through dividends or buy-backs.

I can see no realistic way in which it will be possible for the budget deficits of the UK or the US to come down to a sustainable level, without a large fall in business cash flow. As dividends move over time with profits, this fall must come from some combination