

Private Sector Financial Balances 1980-2012: Contrasting Experiences of Australasian and Northern European Countries.

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Introduction

We are used to receiving messages about government debt. Indeed it is common practice for commentators to talk or write of a country's public debt as that country's debt or national debt. Further, we are virtually pre-programmed to think of debt as something bad, something undesirable, even sinful (Atwood 2008).

The public debt is of course the stock variable that represents the accumulation of governments' fiscal deficits. Additionally, a country's external debt is its accumulation (if any) of balance of payments' current account deficits. (Indeed the mercantilist wiring of our brains instinctively interprets the words 'deficit' and 'debt' as something 'we' should avoid¹; somebody else should have them instead.) Almost all countries have a public debt, whereas we would expect half of all countries to have an external debt.

We have got used to the idea that debtor countries – countries with external debt – are also deficit countries, to the point that we tend to categorise countries as deficit or surplus countries, rather than as debtor or creditor countries. Yet, in a rebalancing phase of the global economy, debtor countries would be surplus countries; and creditor countries would be running current account deficits. This possibility seems hard to imagine, in part because it is historically rare. Financial habits may be quite ingrained (Rennefanz 2008, Kollwe 2012). The rational creditors' bargain – consume less now and substantially more later – is rarely fulfilled. Habits of abstinence are not easily reversed.

Public sector (fiscal) balances are the same as general government fiscal surpluses; ie negative fiscal deficits. Foreign balances are the financial-capital balance of the balance of payments, essentially negative current account balances. We determine private sector balances as the residual of these two: a country's current account balance minus its fiscal balance (Wray 2011, Fullwiler 2009, 2011).

To get a full macro-view of private financial behaviour, it is desirable to split private balances into household balances and corporate balances. However, and given the relative ease of calculating aggregate private-sector balances, and difficulty of such disaggregation, this analysis generally uses combined household and business aggregates.

This paper will juxtapose the private-sector financial balances of the Australasian and the Nordic countries, and interpret their national experiences through the inter-sectoral lens outlined. It will draw on analyses and experiences of other larger economies where appropriate, and it will start with a global perspective.

Global balances

For the world as a whole, we can only contrast private sector balances with government balances. With two sectors and a closed economy we have just one degree of freedom. Thus

¹ This mercantilist impulse may be especially true today in Germany: Knight (2010) quotes Jonathan Holslag of the Brussels Institute of Contemporary China Studies (BICCS): "The most important objective for the German government is to step up exports"; this, despite large German current account surpluses every year since 2002. Baron (2012) says of a BBC television documentary presented by former British Cabinet Minister Michael Portillo that notes Germany's success as an exporting nation: "What [Portillo] and no mainstream economist seems to realise is that exporting is sending wealth out of the country. Unless goods of equal value are received in return".

the private balance is the negative of the government balance. (Weisenthal 2012b)²

The IMF describe general government balances in this way:

Net lending (+)/borrowing (–) is a summary measure indicating the extent to which government is either putting financial resources at the disposal of other sectors in the economy or utilizing the financial resources generated by other sectors. It may therefore be viewed as an indicator of the financial impact of government activity on the rest of the economy. (IMF 2001)

Equally, we may view private balances as an indicator of the financial impact of private sector activity on the government sector. Although private intentions may be influenced by monetary policies, in essence private activity is autonomous; rarely if ever does a private sector agent act with the intent of balancing the system. Equilibrium exists when intended balances balance; when intended private surpluses/deficits match intended government deficits/surpluses.

The global economy can be said to be in financial equilibrium if the combined financial intentions of all decision-makers sum to zero. If they sum to less than zero, then desired spending exceeds desired saving; the system is subject to a stimulus and some adjustment must take place, for example through increasing interest rates. If they sum to more than zero, then desired saving exceeds desired spending and adjustment may take place through decreasing interest rates or unemployment.

The IMF description of net government lending – "an indicator of the financial impact of government activity on the rest of the economy" – is strictly only true when the system is in equilibrium. It is written as if government activity is fully exogenous, and the private sector accommodates to a given level of government activity.

As noted, we can equally say that net private lending is an indicator of the financial impact of private activity on governments. Governments, indeed, may not choose to use all of the financial resources made available to them by the private sector. If both the private and government sectors are attempting to place resources at the present disposal of the other sector, then resources will become unemployed, and neither sector will achieve the balances that they intend.

Governments can more easily be accommodating in their behaviour, than can private agents³; their intentions can intentionally offset private sector intentions. Governments have 'intelligence', in both senses of that word. There are fewer governments than there are private sector agents; governments are better placed to see the bigger picture and can more effectively operate in a countercyclical way. Thus, at least since Keynes, governments generally understand that they may use accommodating behaviour as a policy principle.

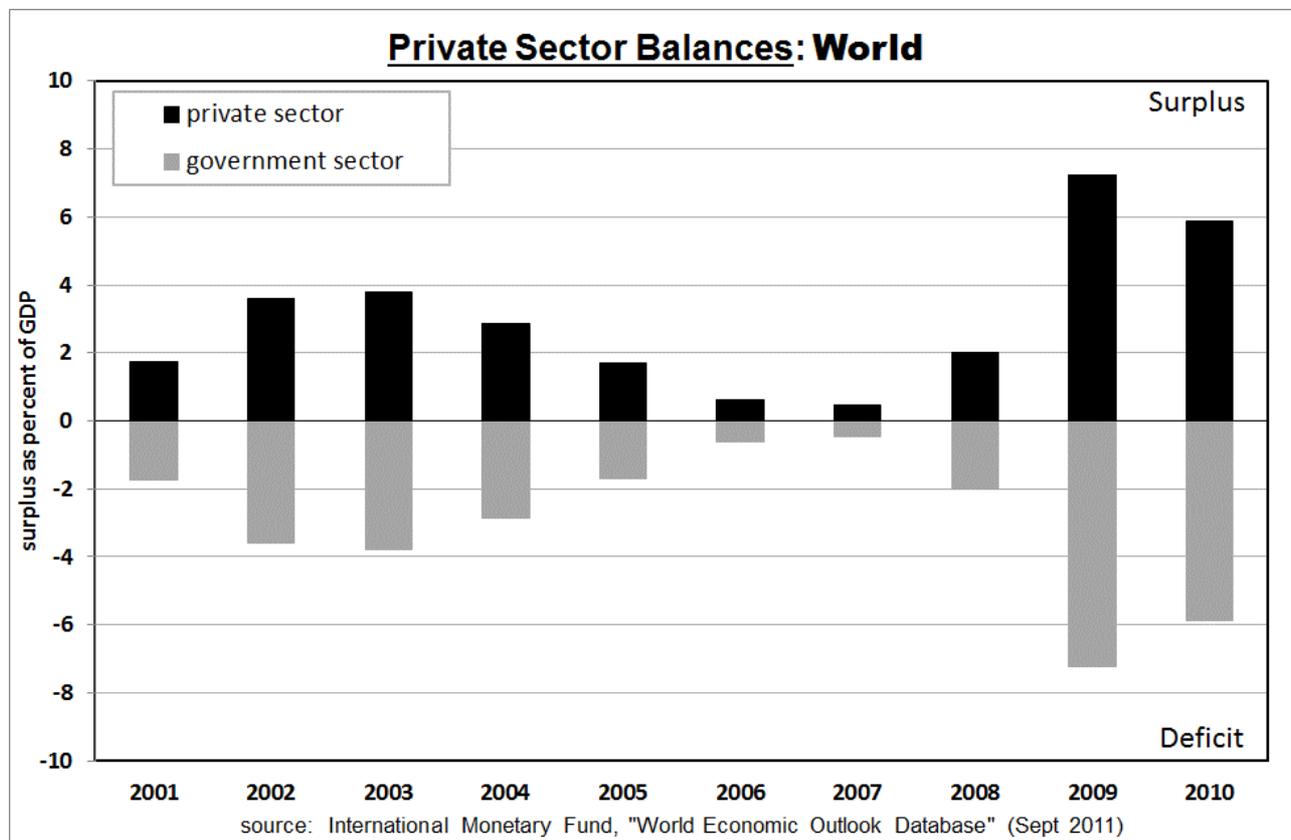
We may therefore understand the private sector balances in Figure 1 as being substantially

² Weisenthal quotes Goldman Sachs' Jan Hatzius: "If you start with the global economy, to simplify it, that every dollar of government deficits has to be offset with private sector surpluses purely from an accounting standpoint, because one sector's income is another sector's spending, so it all has to add up to zero. That's the starting point. It's a truism, basically. Where it goes from being a truism and an accounting identity to an economic relationship is once you recognise that cyclical impulses to the economy depend on *desired changes* [my emphasis] in these sector financial balances." Harrison (2012) notes that "some economists have dismissed [this approach] as an accounting 'tautology'".

³ Such direct private sector accommodation is called Ricardian Equivalence (Wolf 2012b, Mishkin 2007 p.627), and, while believed by some, is highly contentious.

autonomous, and the government balances as being substantially accommodating. Hence the post-2008 government balances are a requirement of the huge shift in private sentiment, in favour of precautionary savings and debt reduction. Voluntary accommodation by governments should be understood as countercyclical fiscal policy.

Figure 1



Monetary policy, which requires feedback into a possibly stubborn private sector, may also achieve equilibrium in an ordinary recession or inflation (Koo 2009), but not in a 'balance-sheet recession'. Alternatively, self-accommodation may in principle result from global interest rates freely acting as a balancing variable. We note however, from Figure 1, that in the high interest rate environment of 2006-07, private balances were low, and in the low interest rate post GFC (global financial crisis) environment of 2009-10, private balances were very high, and desired private balances were almost certainly much higher. (One important case in which self-adjustment through interest rates generally cannot occur is in situations in which the interest rates required to achieve balance are negative.)

We must also understand that, where voluntary inter-sectoral accommodation does not take place, then forced accommodation between the sectors must occur, given that the two sets of balances must add to zero. Forced accommodation occurs when neither policy-accommodation nor self-accommodation takes place. Forced accommodation, imposed on both sectors, is likely to be accompanied by the inflation or unemployment that are symptomatic of macroeconomic disequilibrium.

In Figure 1, we see that in every year the private sector ran a surplus balance, despite the perception of massive and unserviceable private debts (eg sub-prime mortgages), combined

with very high financial leverage, being the root causes of the 2008 global crisis. We note that, in the United Kingdom (Economist 2012a), the United States, Canada, Japan and probably in most other developed countries, corporate savings from 2003 were substantial (Economist 2012b), meaning that the private debt excesses of the mid-2000s were essentially household debts.⁴ Neoclassical theory, which points to businesses as the most appropriate debtor sector, provides little illumination on this point.

For the world as a whole, we can see that the private sector is a creditor-surplus sector, and the public sector is a debtor-deficit sector. The global financial crisis has starkly accentuated this pattern. The global economic recession can be understood as resulting from the failure of governments to wilfully accommodate massive private-sector surpluses, as businesses reduced debt and hoarded profits and households tried to reduce debt and save more. The global 'balance sheet recession' (Koo, 2011) ensued, with governments running bigger deficits than they wished to, and private sector agents running smaller surpluses than planned.⁵

The net financial wealth of the world's private sector is its claims on the world's governments.⁶ The private sector entered a wealth accumulation phase in the early 2000s, and a more substantial phase of accumulating financial claims against the world's governments after 2008.

Nordic versus Australasian countries

When we move from the global to the national point of view, each country has three sectors – private, government, foreign – and therefore there are two degrees of freedom. Thus individual countries may have positive (or negative) private and government balances. But, clearly, not all countries can! Sweden and Finland in the 1990s became good and persistent examples: private surpluses, government surpluses and current account surpluses.

In this paper, I will look at the post-1980 inter-sectoral financial balances of the two Australasian countries (Australia, New Zealand) and the five Nordic countries (Sweden, Denmark, Finland, Norway, Iceland). We may note that the Australasian gross regional product approximates in size to the Nordic gross regional product.

Since the mid-1990s, the Nordic countries' private balances – especially Sweden, Denmark and Finland – show as a mirror image to those of Australia and New Zealand. Refer to Appendix to see the charts. These Nordic countries show as domestic savers while the Australasian countries fall well into the spender category. (Indeed, if you cancel out the rest of the world, from 1993-2004, Finland's private sector was effectively creditor to New

⁴ For business surpluses this century: see chart in Roche (2012), Koo (2011, p.26) for USA; Economist (2011, 2012a), Koo (2011, p.26) for UK; Economist (2012b), Koo (2009, p.21) for Japan; Economist (2012b, 2013) for Canada.

⁵ Kelton (2011a, 2011b) explains the situation well, without using Koo's "balance-sheet recession" label. She shows how politicians, including US President Obama, completely misunderstand the requirement for inter-sectoral accounts to balance. Kelton (2011a) quotes Obama "small businesses and families are tightening their belts. Their government should, too." The bigger concern is that few economists, who know better, act to correct these popular misconceptions. Perhaps too many economists simply assume that government activity always crowds-out private activity? Angela Merkel, Germany's Chancellor, makes the same mistake when she argues that governments should economise in the same manner as Swabian housewives.

⁶ Wray (2009): "Government debt is a private asset. You and I do not owe government debt, we own it." Of course we both own it and owe it.

Zealand's private sector.)

In the 1980s it was different. Indeed the economic history of the Nordic countries pre-liberalisation is very similar to that of New Zealand (Honkapohja, McAloon). The households and businesses of Sweden and Finland, along with Australia and the United Kingdom, appear to have become darlings of the world's capital markets following the world financial crisis of 1987. The 1980s' picture, combined with the more recent experiences of Iceland (see Appendix charts), suggests that Scandinavians do not have a greater embedded cultural propensity to parsimony than English-speaking households do.⁷

Sweden and Finland experienced systemic banking crises in the early 1990s (Ingves 2002, Honkapohja 2012, Kindleberger and Aliber 2011). So did Australia⁸ (Stanford 2010). Finland and especially Sweden have become poster-children for the political resolution of banking crises, especially on account of Government bail-outs of banks that required injections of equity rather than debt capital (Dougherty 2008, Ingves 2002). Risk and reward were shared, rather than simply a socialisation of the banks' losses (Bertram 2009).

Denmark's inter-sectoral pattern of activity was similar to Sweden's in the 1980s up to 1987, but, unlike Sweden and Finland, showed spending restraint after 1987. Honkapohja says "Denmark experienced some banking problems but managed to avoid a systemic crisis." While Norway became a special case due to its North Sea Oil boom, its activity followed the same general pattern in the late 1980s and early 1990s; like Finland to 1987, like Denmark after that. (Norway was unusual for resource boom countries; its windfall revenues were retained by government, showing up after 1996, and especially after 2000, as large current account and fiscal surpluses).

New Zealand experienced its financial crisis in 1987 following its most significant sharemarket mania in the 20th century (McAloon 2013, p.204), and a banking crisis in 1988-90 (Hunt 2009 pp.36-7)⁹. This was timed with the world stockmarket panic of 1987, but with domestic conditions (linked to financial liberalisation in 1985) substantially aggravating the crisis in New Zealand.

Like Japan, our countries Australia, Sweden and Finland all dodged the 1987 financial crisis with little economic damage, and experienced much lower private balances than usual from 1988-90. They suffered later however, especially in 1991, with their own banking crises.

⁷ Unlike Germany, possibly. Germany, described as 'one of the very few countries of the world running a balance of payments surplus' (!?) allegedly has a cultural disposition towards credit balances. 'Cultural differences are just as significant - quite simply, Germans are uncomfortable with the concept of borrowing money and prefer to live within their own means. "In German, borrowing is 'schulden', [the same word for] guilt. There is an attitude that if you have to borrow, there is something wrong with you," says Mr Kohl [David Kohl, deputy chief economist at Frankfurt-based Julius Baer bank]. We might also note that the English word "guilt" derives from the German word – geld – for money. (Anderson 2012). Further "Germans simply don't understand Britons' relaxed attitude towards borrowing money" (Rennefanz 2008). Australasians would appear to be at least as relaxed as Britons towards debt. While Scandinavians appear to have been more relaxed towards debt than Germans in the 1980s, unlike Australians they may have become less relaxed about debt, despite similar experiences of banking crisis in the early 1990s.

⁸ The best known casualties of the Australian crisis were the State Banks of South Australia and Victoria. A number of non-bank financial intermediaries also failed at this time. Of the big four banks, Westpac in particular suffered, with 9.3% of its asset portfolio becoming problem loans (Stanford). Westpac's problems may have begun with its New Zealand operations during the mid-1980s sharemarket mania. ANZ, also exposed to New Zealand, had the next highest proportion of bad loans (6.9%).

⁹ The principal casualties were the Bank of New Zealand in 1988 and 1990, the United Building Society in 1988, and the Development Finance Corporation in 1989. The second failure of the BNZ could more properly be seen as a part of the developing Australian banking crisis (Hunt p.37).

Australia saw casualties in the State Banks of Victoria and South Australia. Further, the Bank of New Zealand failed for the second time in three years, this time due to the insolvency of its Australian operations.

Broadly, the experiences of the Australasian countries and the Nordic countries were similar from 1980 until the early 1990s. After that the two groups diverged, with the Nordic countries showing 'surplus' profiles, and the Australasian countries showing the most persistent deficit profiles in the developed world.

The Scandinavian response to its banking crisis shows a similar pattern to those of, for example, Malaysia and Thailand after their 1997/98 experiences of the Asian financial crisis (see Appendix). There has been a persistent trend of domestic saving being matched by foreign lending. With the exception of Iceland, the Nordics have adopted the profile (like Germany) of successful mercantilist economies with a seemingly perpetual preference for substantial current account surpluses. Only Finland has wavered in recent years.

The contrasting New Zealand private-sector experience from the early-mid 1990s, and to a lesser extent the Australian experience, has the look of being accommodating of foreign sector surpluses, albeit unintentionally. The private debt profile of these two countries in the 1990s and 2000s looks somewhat more dramatic than those of Sweden, Finland, Thailand and Malaysia in the lead-up to their financial crises. Yet both countries seem immune from the kinds of difficulties faced elsewhere.

Pre-liberalisation experience (ie before 1985 in New Zealand) does not suggest that New Zealand or Australia have a cultural propensity to debt, or to spendthrift behaviour. Possibly there is a lesser fear of debt in Australasia, as its people have so far experienced fewer adverse consequences of excessive debt. In New Zealand's case, and to a lesser extent Australia (Stanford 2010 p.21), the fear was focussed on the sharemarket, because that's where the real losses took place in 1987.

How have the private sectors of New Zealand and Australia accommodated foreign surpluses in the years after 1992? Monetary policy seems to be the likely candidate.

In the years before 1985, the principal concern of policymakers in New Zealand was the balance of payments (McAloon 2013 p.199). Subsequent to liberalisation it became inflation. This concern was etched into New Zealand law through the 1989 Reserve Bank Act¹⁰, with New Zealand's adoption of an explicit inflation target¹¹ of 0-2 percent. Further, in 1985 New Zealand had floated its currency, adopting a clean float whereby monetary policy only – and indirectly at that, through interest rates – was able to influence the exchange rate.

Especially during years of high world economic growth, the Reserve Bank of New Zealand (RBNZ), believing that it was reducing inflation, would set interest rates high enough to attract substantial savings from the world's private savers; substantial enough to cause the floating New Zealand exchange rate to rise substantially despite very high current account

¹⁰ McAloon (2013, p.208). New Zealand became the first country in the world (Mishkin 2007 p.404) to adopt formal inflation targeting, to be conducted by an independent central bank. Later, in 1994, the new Fiscal Responsibility Act (McAloon 2013 p.214) meant that the Reserve Bank became in effect the only agency able to conduct accommodating stabilisation policy.

¹¹ Koo (2009, p.125) refers to the "problem with unorthodox monetary accommodation" and "inflation targets and other unorthodox monetary policy tools".

deficits. The effect of high exchange rates, much higher than New Zealand's trade balance would justify, was to induce high amounts of debt-enabled spending. So long as New Zealand was seen to have the future capacity to service debt through primary sector exports, the creditors didn't seem to mind the extended profile of private debt.

Koo (2009) explains Japan's experience in the 1990s and 2000s as a 'balance-sheet recession', which could have been instead a dramatic depression had not the Japanese government, for the most part, not followed a fiscal policy that accommodated Japan's massive private-sector surpluses.¹² Japan's private surpluses, like those of Scandinavia, Germany and a number of other mainly Asian and Northern European countries, were also accommodated by other governments, and, as suggested, by private sector debtors in other countries. In an extended passage, Koo (2009, pp.200-9) explicitly links Japanese and New Zealand capital flows. New Zealand is at the "other extreme" from Japan. New Zealand's chronic negative balances accommodate the chronic private surpluses of Japan. The same account could be given by substituting Finland or Sweden for Japan.

The situation in Australia in the 1990s and 2000s was little different to that in New Zealand. Even though there were significant differences in the legislation governing the two Reserve Banks, in practice the Reserve Bank of Australia raised interest rates on a similar basis to its sister institution in New Zealand.

With Swedish, Finnish and now Danish savers funding Australian and New Zealand spenders, there is an argument that we have a win-win outcome. The Scandinavian and the Australasian private sectors have achieved the balance profiles that they have sought. Scandinavians since 1993 have accumulated financial assets, while New Zealand and Australian consumers have enjoyed a full array of the world's consumer goods, including Nordic mobile phone technology.

Yet this cosy complementariness poses some obvious long-term dangers; unresolved and possibly as unresolvable as the imbalances within, for example, the Eurozone.

Long Term Imbalances

Since the mid-1990s in particular, we have seen a pattern of creditor economies running persistent private-sector surpluses, with the 2008 global financial crisis only accentuating that pattern. Thus projections of long run imbalances between economies extend into the future indefinitely.

The global economy may grow as normal, in normal years, so long as both governments (as in Japan) and central banks (as in Australia and New Zealand) persist with policy settings that accommodate an increasing private preference to accumulate financial assets without any clear intention of realising those assets in the form of deferred consumption of goods and services. That increasing preference is exemplified by the experiences of the Nordic countries.

Global financial crises seem likely to become more frequent under these conditions, as accommodating debtor parties become fewer, and more indebted, and creditor hoards accumulate, abated only by the difficulties of finding accommodating sectors elsewhere.

¹² This was a case of "getting out of debt by adding debt", in the phraseology of Wolf (2012b).

This scenario of escalating financial crises was characteristic of the entire gold standard (Ahamed 2009 p.14) era from the mid-nineteenth century to the 1930s (Kindleberger and Aliber 2011). By the onset of World War I the private sectors of the UK and France in particular had accumulated huge financial balances with respect to the emerging economies (Eichengreen and Temin 2000). World War I itself may have been in part endogenous to this highly unbalanced financial state of the global economy.

The story of the 1920s is well known, with all four of the world's major economic powers trying to be net lenders to the world, and with a conspicuous absence of accommodation by governments or peripheral economies. (In Germany's case, the need to run surpluses was a requirement of the 1919 Versailles Treaty; a requirement to run current account surpluses imposed on Germany by the other three powers, contrary to their own interests, conceived in the mercantilist terms of that era.) The Great Depression of the 1930s would appear to be an inevitable consequence of this unaccommodating 'race to the bottom'.

Context and Conclusion

Countries' inter-sectoral balances must be interpreted with caution. They add context to other information about the changing economic and financial environments that they face. As an analytical tool, they are much more than the "accounting tautology" they have sometimes been dismissed as (Harrison 2012). Indeed forecasting economists such as Wynne Godley (Schlefer 2013) and Goldman Sachs' Jan Hatzius (Wiesenthal 2012a) gained industry reputations for their application of the inter-sectoral balances framework.

However certain patterns do emerge that suggest that, as peoples learn specific national lessons from financial crises (for example, the Nordic countries), the global economy may become increasingly exposed to major economic contractions as each country's private sector turns to increased saving and debt reduction as its salvation. Where governments do not accommodate these desired private balances, then stability is only maintained when other countries' private sectors desire, or at least accept, the requisite negative balances.

Australia and New Zealand have the look of economies yet to experience a regional financial crisis on the scale of the Scandinavian crisis of the early 1990s or the Asian crisis of the late 1990s. As each of these debtor-deficit economies passes through such a crisis, there become fewer economies left to accommodate the increasing number of economies displaying creditor-surplus behaviour at both private and government levels.

The financial balances approach emphasises that the short-run health of the global economy depends on accommodating behaviour. For such balancing to continue into perpetuity, then different countries' private sectors have to take their turns at playing an accommodator role. It means that creditor economies and sectors have to take their turn at running deficits, so that debtors can run surpluses. This is, I believe, the number one lesson of the global inter-war economy. I am not confident that this lesson has yet been understood.

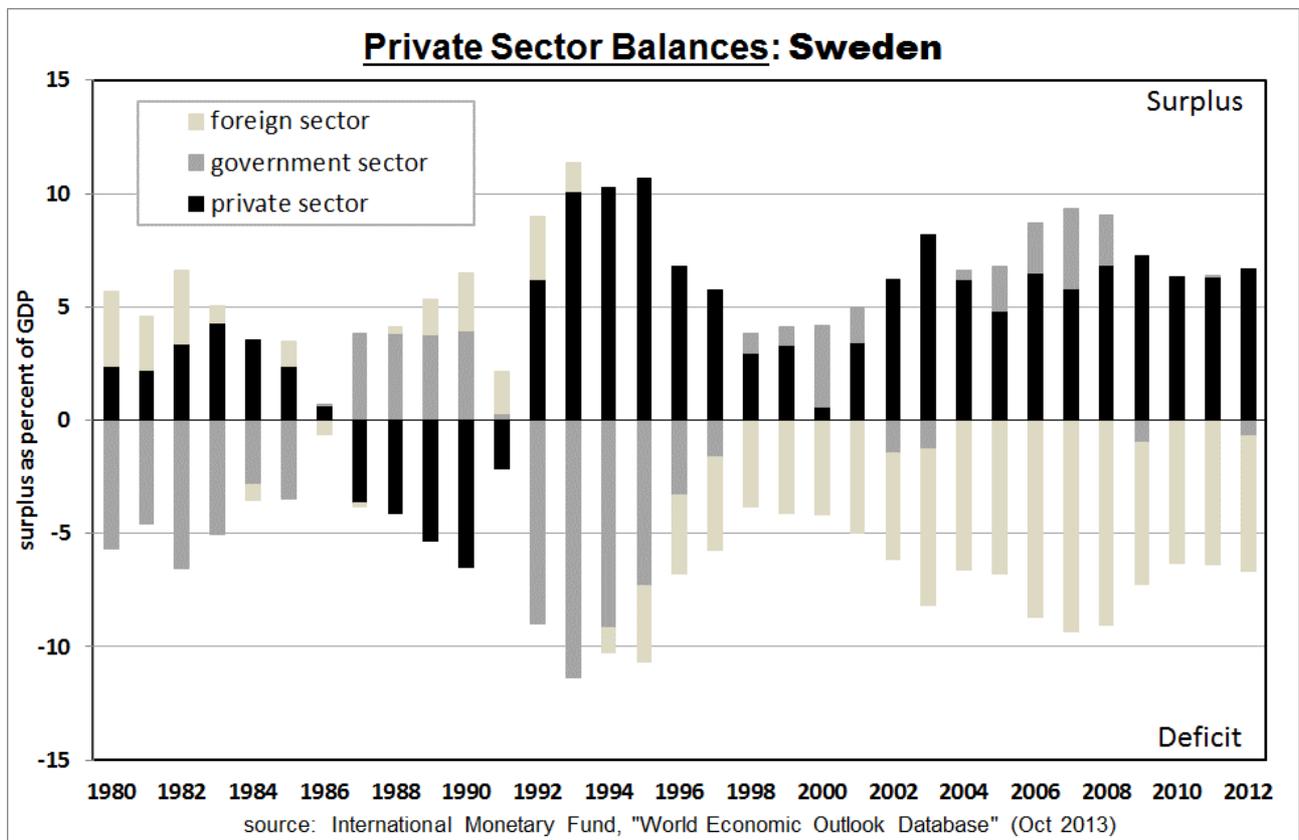
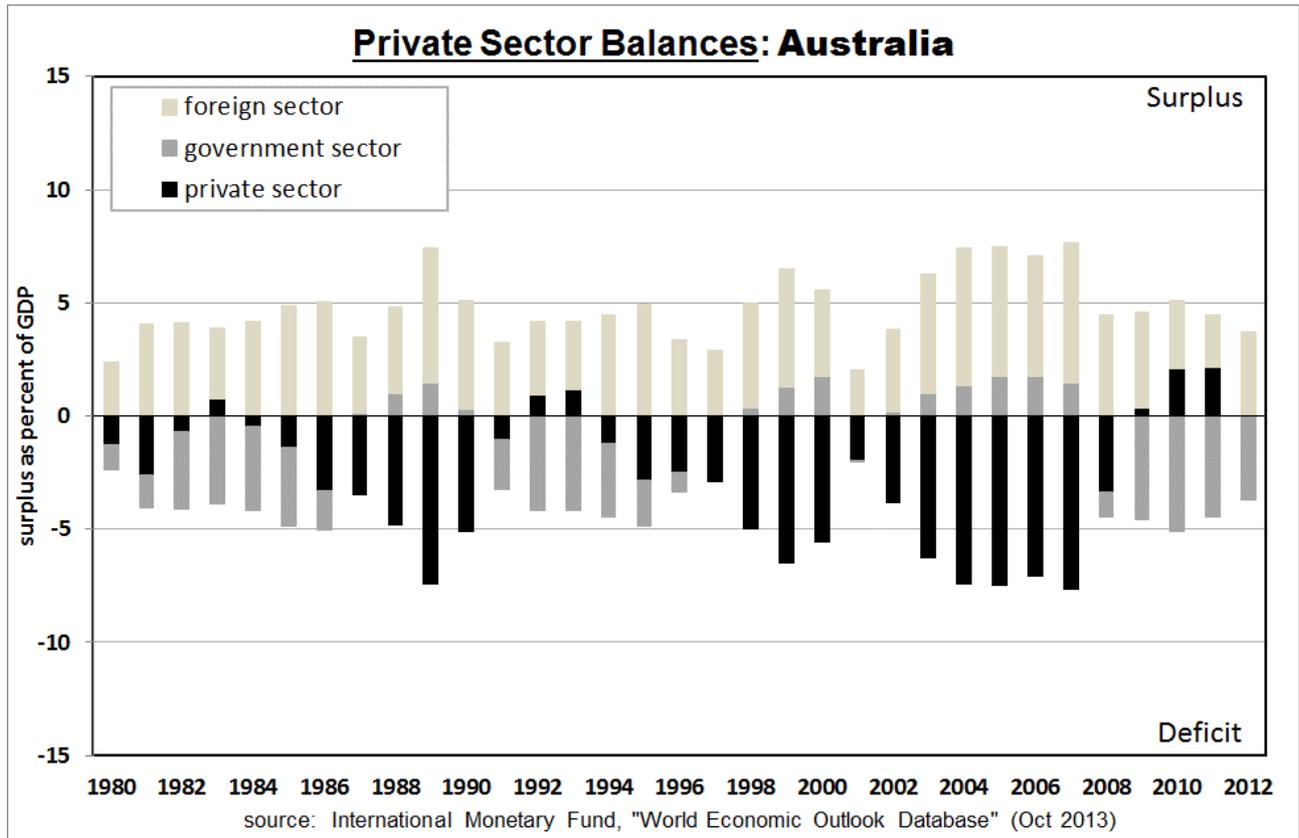
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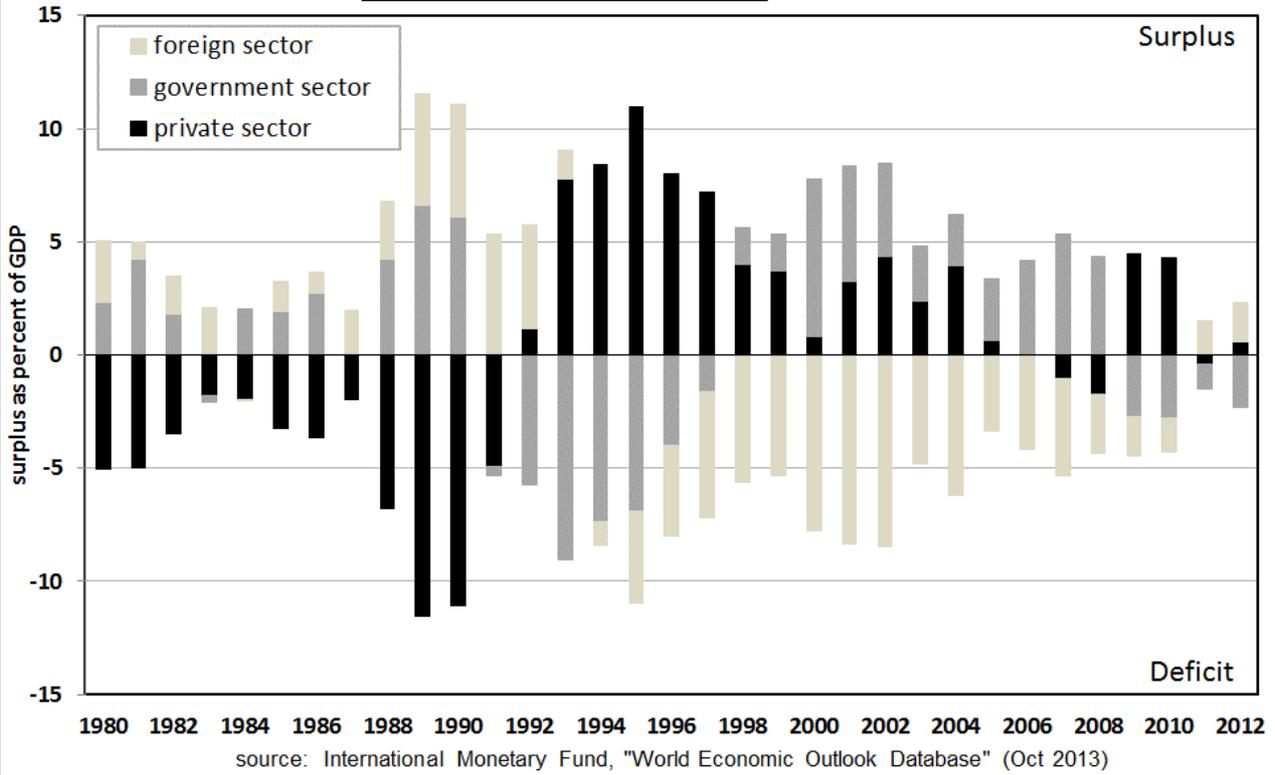
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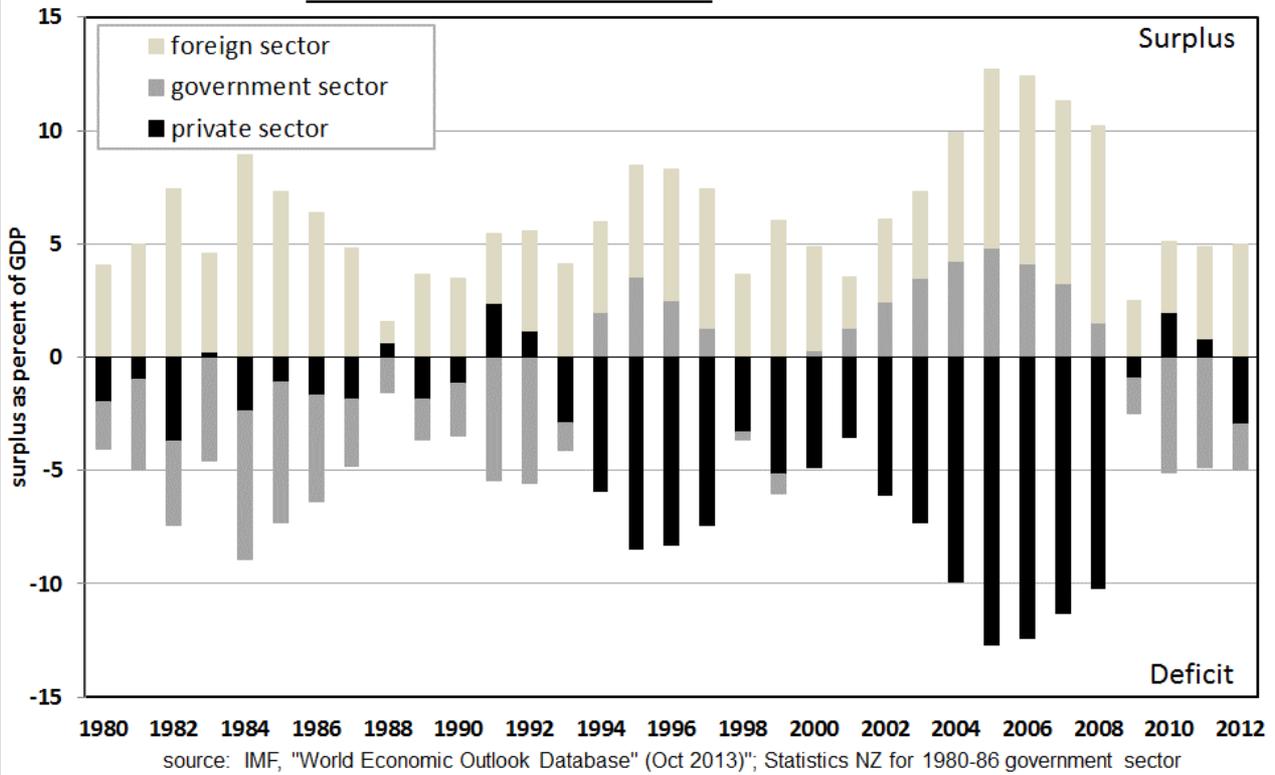
Appendix



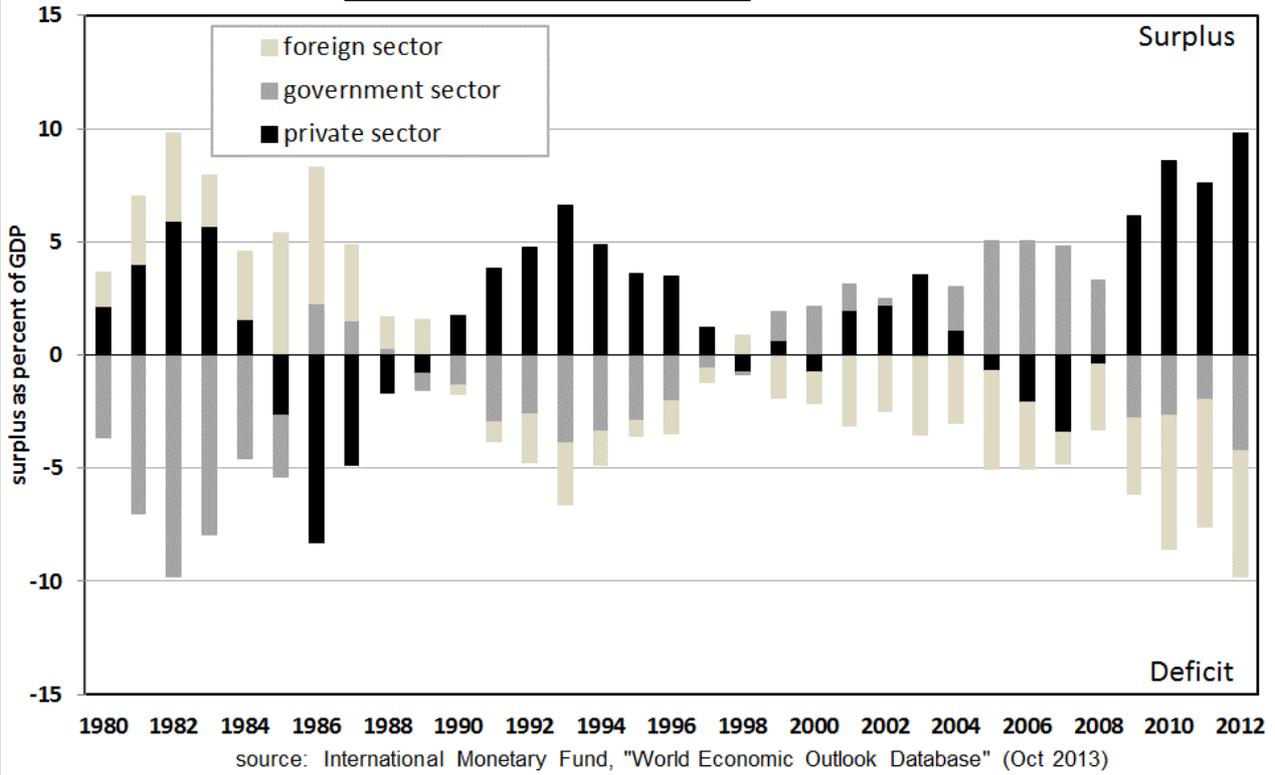
Private Sector Balances: Finland



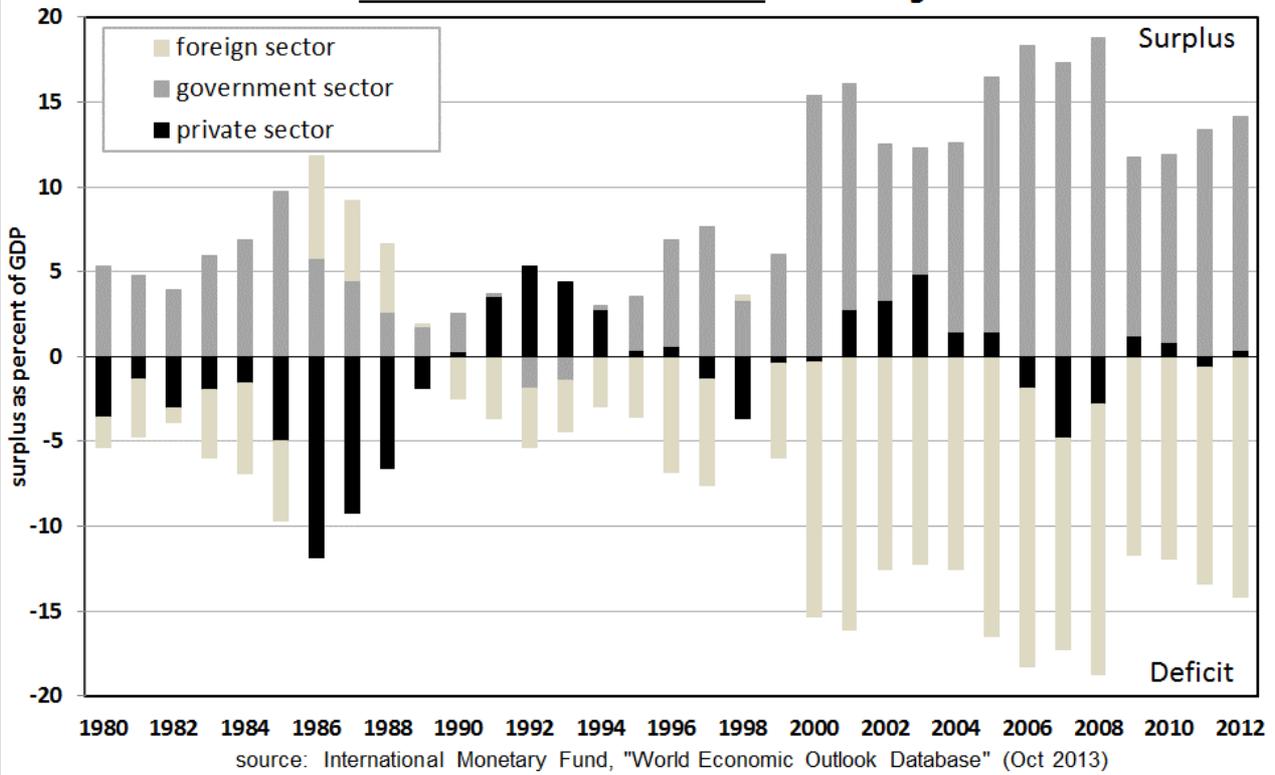
Private Sector Balances: New Zealand



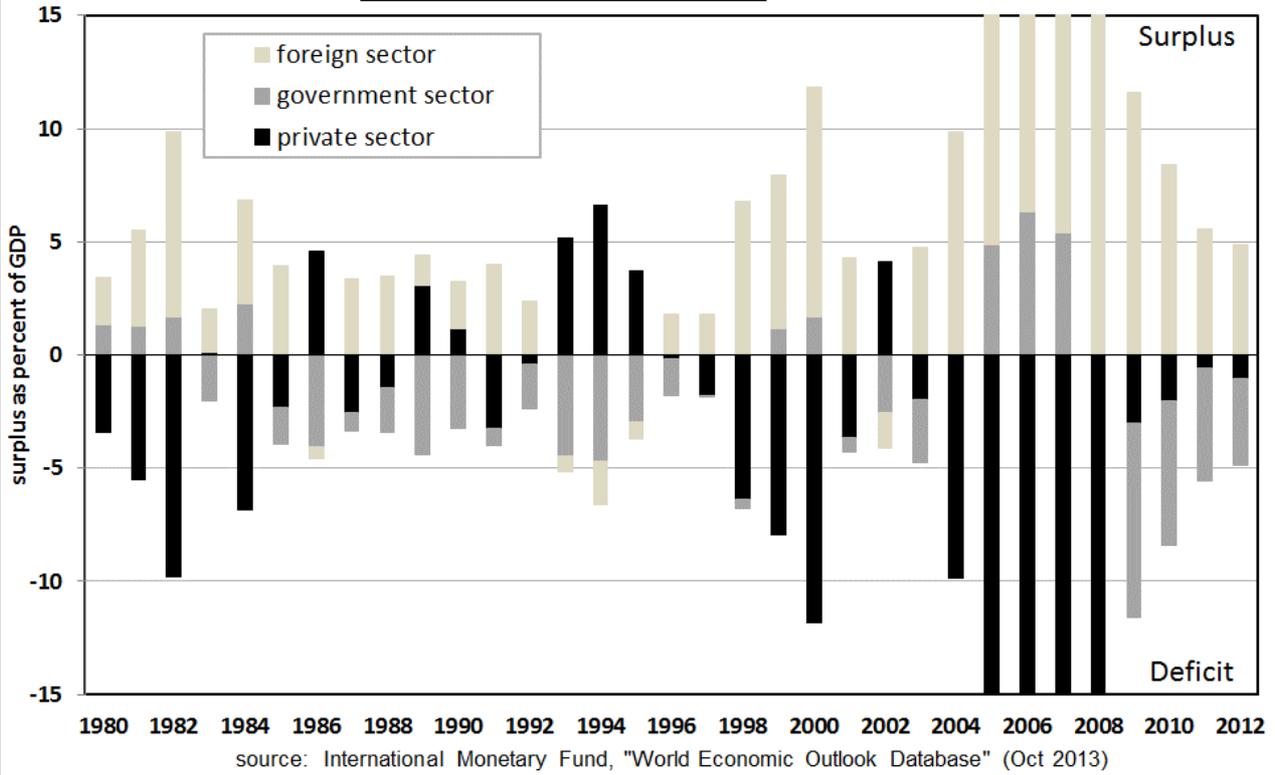
Private Sector Balances: Denmark



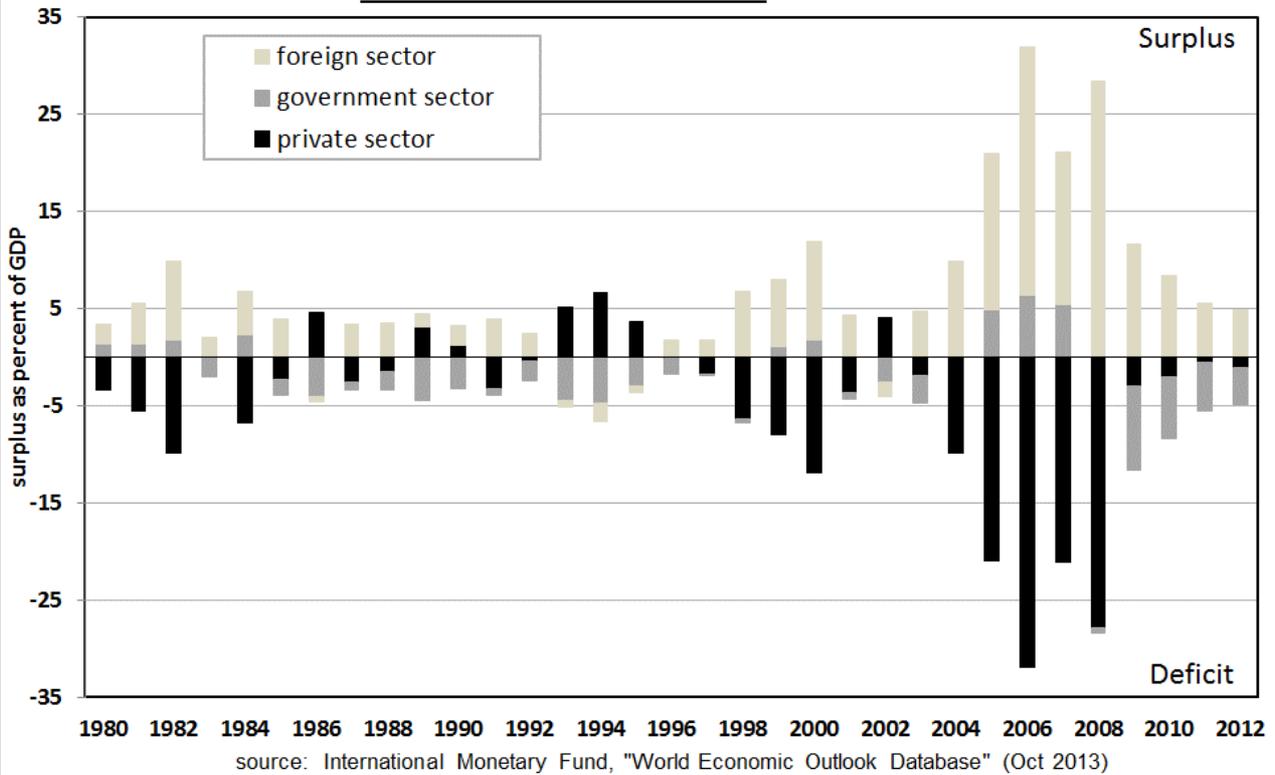
Private Sector Balances: Norway



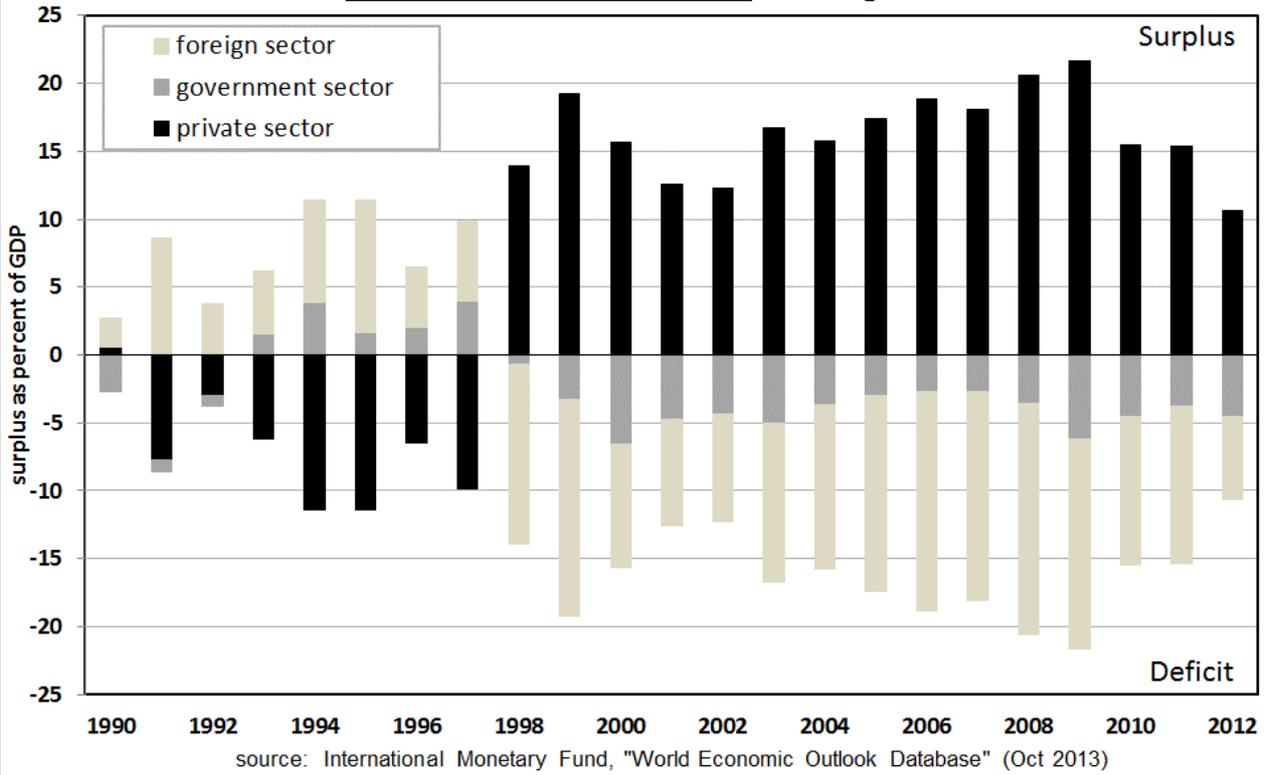
Private Sector Balances: Iceland



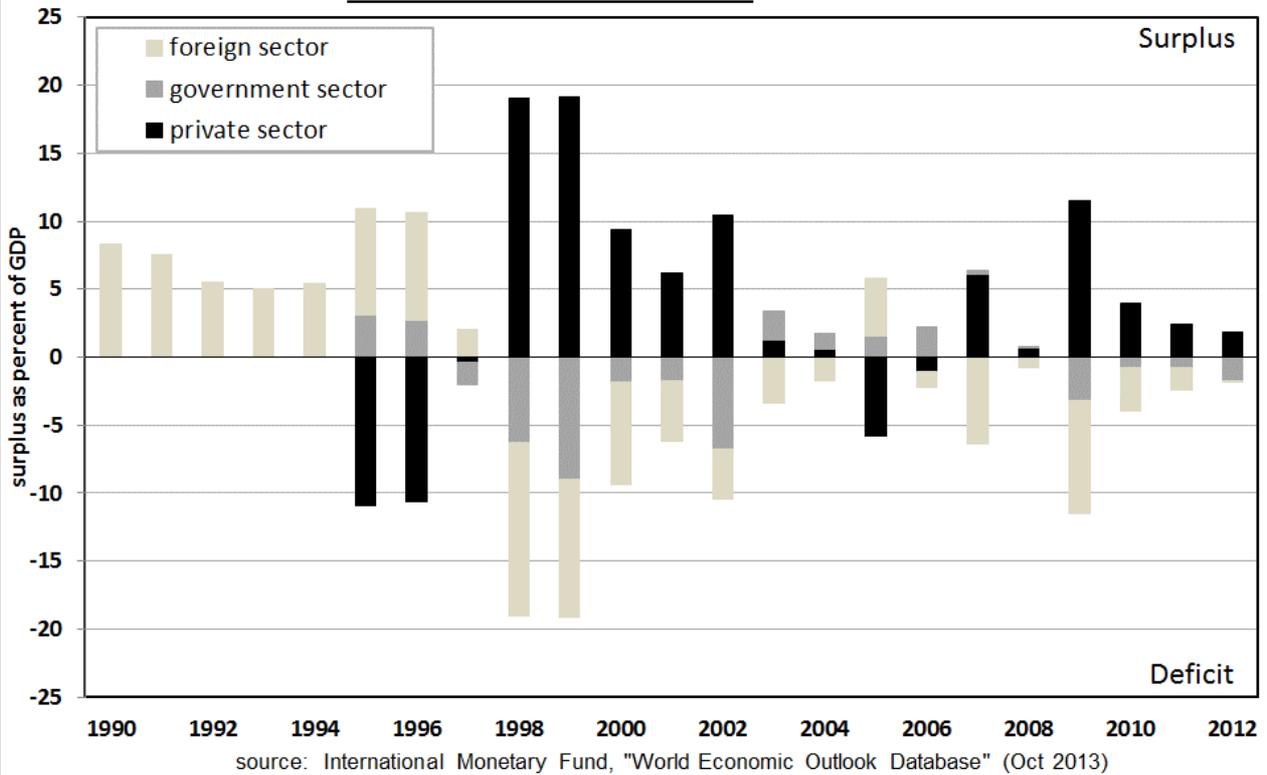
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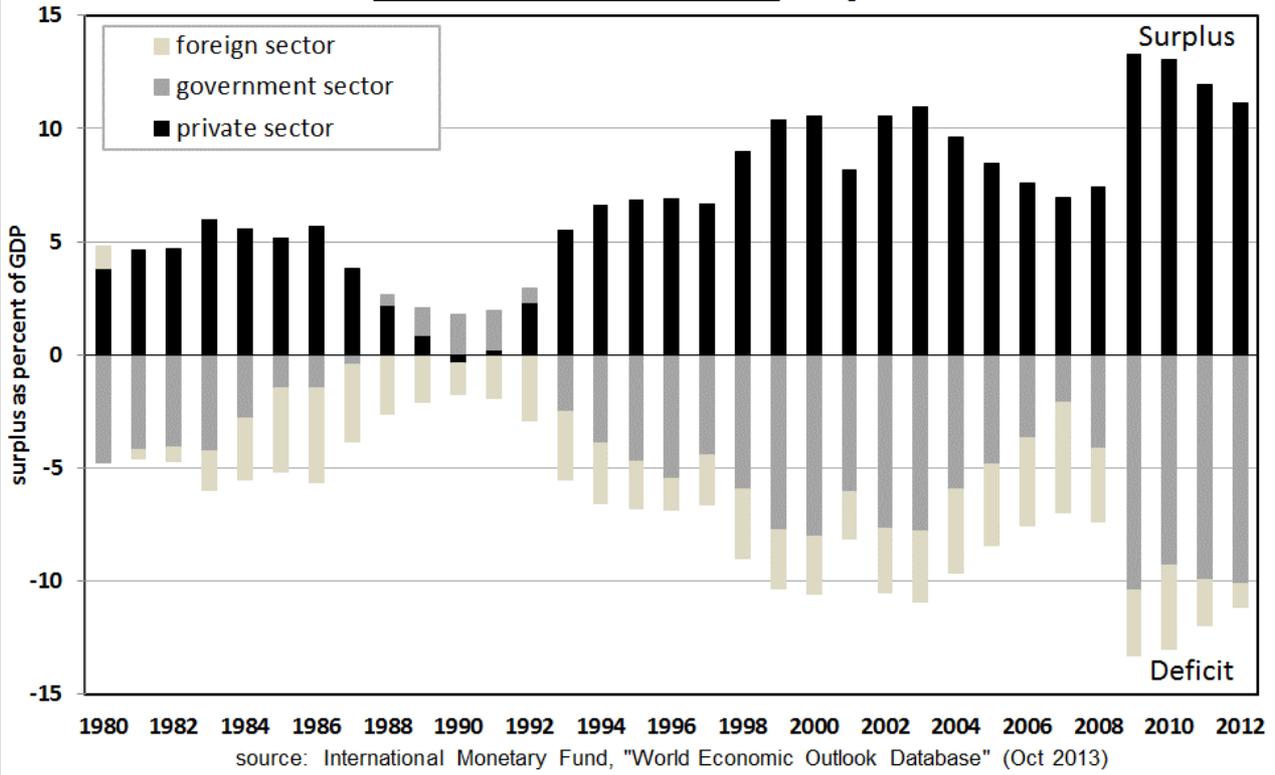
Private Sector Balances: Malaysia



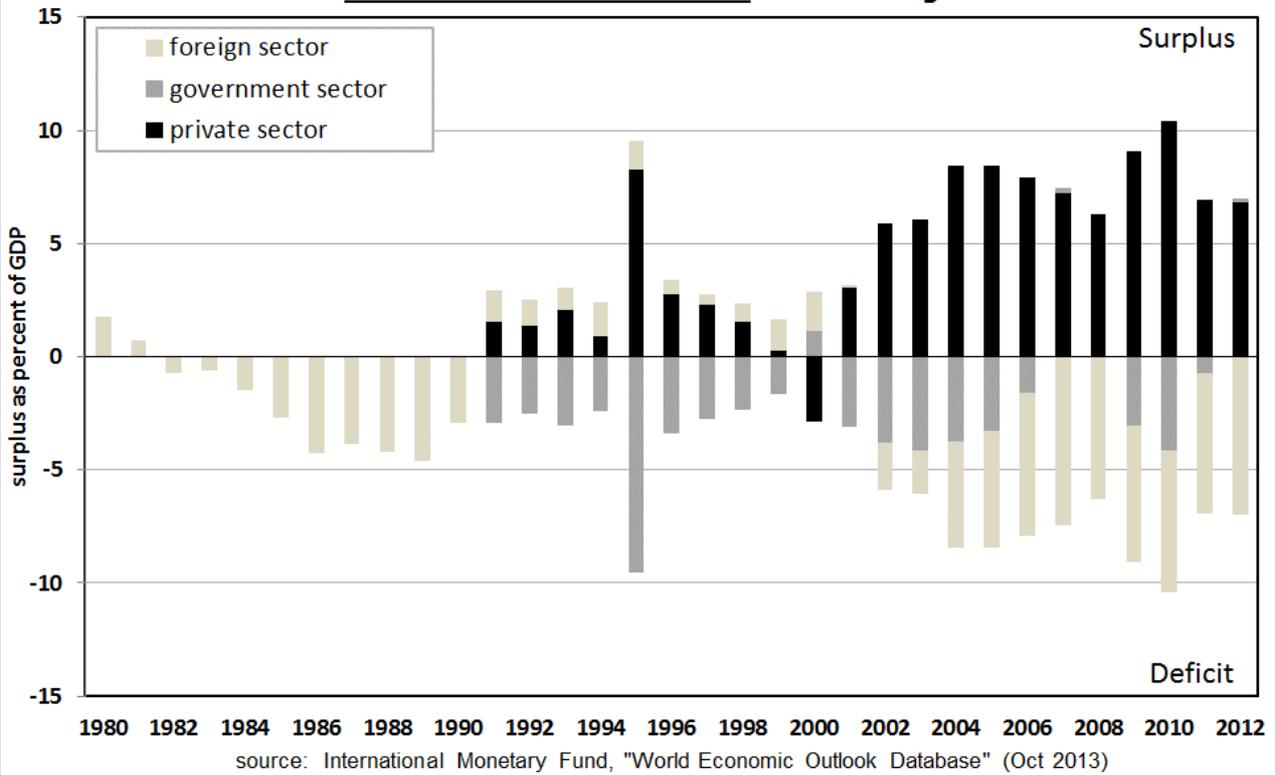
Private Sector Balances: Thailand



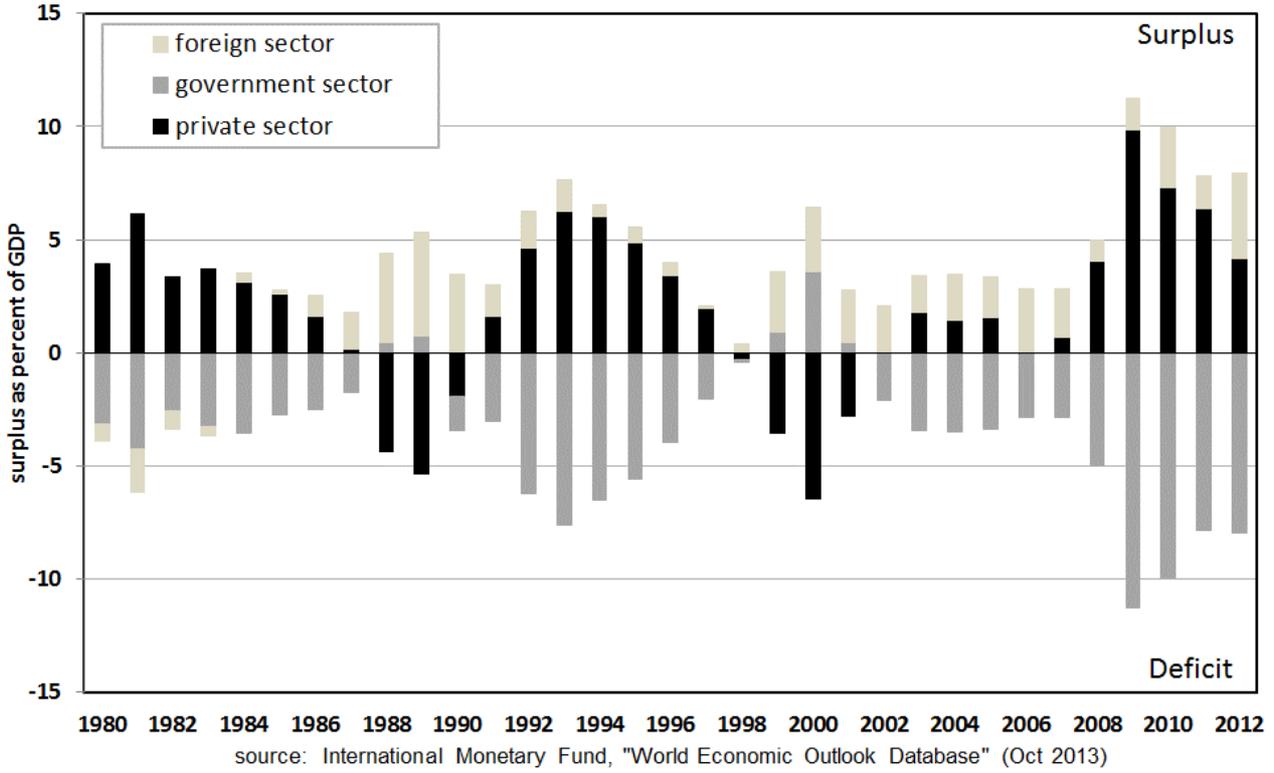
Private Sector Balances: Japan



Private Sector Balances: Germany



Private Sector Balances: United Kingdom



Private Sector Balances: USA

