Are we there yet?

(Article prepared for Handelsblatt)

All parents who have gone on car trips with young children know how they constantly repeat the question "Are we there yet?" Today, a similar question is being asked about the end of the financial and economic crisis, and in a similar spirit of hopefulness. An important difference, however, is that the child's questions are only aggravating, whereas excessive optimism in current circumstances could be positively dangerous. There are policy measures that need to be implemented to get us out of this mess, some of them painful, and excessive hopefulness threatens to blind us to the need for resolute action.

It took more than twenty years for the imbalances underlying the current crisis to build up. Easy monetary policies and financial innovation led to very rapid credit and monetary expansion at the global level. While this might have led to inflation, such potential pressures were for a long time offset by massive increases in productivity linked to globalisation. Instead, the effect was to bid up asset prices, increase the exposure of financial institutions to bad loans, and induce unsustainable patterns of spending. In the English speaking countries, and some others in Central and Eastern Europe especially, spending on consumption and housing rose to record heights. In contrast, fixed investment in China rose to an unprecedented proportion of all spending, with much of it supporting exports. In turn, these divergences in spending behaviour made a significant contribution to global trade imbalances, which also became increasingly viewed as unsustainable.

Those that hope these long standing imbalances can be worked off adequately in the space of months, or even a few years, are likely to be gravely mistaken. The financial sector remains over-leveraged, and it will take time and pain before this is adequately reversed. The household sector in many important economies also remains over-leveraged, and the same point would apply. In this regard, today's downturn is completely different from most others in the post-War period. Earlier downturns were due largely to higher interest rates designed to cut spending to reduce inflation. The upshot was that, when the upturn came, there was a significant degree of pent-up demand to give impetus to the recovery. Moreover, the banks were eager to provide the needed financing. In both respects, the very opposite is the case today. In many countries, there is an overhang of recently purchased but long lived goods, like cars and houses, as well as the debts incurred to pay for them. Indeed, the debts are so large that the survival of the banks themselves has been threatened, inducing them to tighten credit conditions sharply.

Nor, unfortunately, are these demand side effects all that will affect the adjustment process during the bust. The supply side is arguably likely to be even more important. During the boom, resources were shifted into the production of things for which there will be a smaller market looking forward. The construction, retail sales, banking, automobile and distribution industries in the advanced market economies are all too big, relative to prospective demand. They must and will shrink. Similarly, the export capacity of large creditor countries (traditionally Germany and Japan, but now China as well), now significantly exceeds what many debtor countries can afford to pay for. Absent still more vendor financing, which would imply still bigger global trade imbalances and a still larger build-up of foreign exchange reserves, there must be a reallocation of real productive resources. Creditors must produce more non-tradeables. Debtors must produce more tradeables. This reallocation of resources will also be painful and will take time.

The “green shoots” of growth, associated with the current global inventory cycle, are real. However, the headwinds arising from both these demand side and supply side imbalances seem likely to prove longer lasting.

How one assesses the origins and the likely duration of our current problems has important implications for policy. Absent a quick recovery, the problems of financial institutions will have more to do with insolvency than illiquidity. If it is also the case that our current problems have their roots in too easy credit conditions, then it is not obvious that still more credit for misguided spending should be part of the policy solution. Indeed, if supply side readjustments are required in many of our economies, the level of potential may be significantly lower than many think. This implies that macroeconomic stimulus could have inflationary implications sooner than many expect, particularly in debtor countries whose exchange rates might also be vulnerable. Finally, and again related to the need for supply side adjustments, government measures designed to prop up declining industries will in the end prove expensive and counterproductive. We are not going back to what passed for “normal” in the middle of this decade. The sooner governments realize this, the better.