Managing the Macro End Game

In the Bible, Jesus asks the question "And if the salt shall lose its savor, what then shall it be salted with?" We should be asking ourselves the same question about the efficacy of our macroeconomic tools. Suppose that, like the salt, they have lost their power to stimulate. What then is Plan B?

Ever since the 1950's, when policymakers almost everywhere were converted to "Keynesian economics", their policy response to actual or potential economic downturns has been the same. Fiscal deficits were allowed to rise and interest rates were pushed lower. Both responses were deemed necessary to revive aggregate demand and thus jobs and production. There can be no doubt that such policies succeeded in their near term purpose, and perhaps never more so than during the years of "The Great Moderation" which preceded the current crisis. Since the crisis broke in mid 2007, the policy response has been "more of the same" with many policymakers remaining confident that they will work as usual. It is to be hoped that they are right. Yet it is also worth reflecting on why this might not happen, and what other public polices might usefully be turned to.

An unsustainable level of private sector debt is the main factor explaining the present severe downturn, as well as many previous downturns in history. Today, the problem principally resides in the household sector in many advanced market economies. Consumers have in recent years purchased many long lived assets, and they have the debts to prove it. In Japan in the 1980's corporations went on a similar spree of capital spending which was almost wholly funded by debt. However, the problem with debt is that it is a claim on future earnings. Thus, if expectations about earnings (whether wages or profits) are not realized, then servicing these debts on originally agreed terms grows increasingly onerous.

Such unrequited expectations bring in train a number of unpleasant consequences. Debtors face increasing cash flow constraints and the ultimate threat of bankruptcy. In response, they will at some point choose to cut spending sharply, as did the Japanese corporate sector beginning in the early 1990's. Moreover, creditors can be affected as well if debtors fail to pay since this constitutes a charge on profits and capital. With burdened debtors not willing to borrow, and potentially burdened creditors not prepared to lend, the

stage is set for a severe economic slowdown. An overhang of recently purchased real assets will further aggravate the economic downturn. And in the limit, as in the 1930's in the United States and the 1990's in Japan, deflation can raise the real value of debt and exacerbate the original problem.

If debt problems traditionally originate in the private sector, the public sector cannot be held blameless. Today's unsustainable debt levels have much to do with the repeated use of monetary easing to stimulate consumer demand in successive cycles. Not only did low rates make borrowing more attractive, but the search for yield encouraged financial institutions to find ever more ingenious ways to lend. The repeated use of fiscal measures to support demand raised income levels and made private debt more supportable, but at the same time increased public debt levels. In effect, the use of fiscal policy only substituted public debt for private debt, which now seems likely to pose its own set of problems.

Historical considerations of this sort also help explain why both monetary and fiscal policies may now have reached the limits of their effectiveness. On the monetary policy side, interest rates have ratcheted down and are now essentially at zero. Should the current green shoots wither, unorthodox quantitative and credit easing could be used still more aggressively. Yet, many already worry about a rise in inflation (say via commodity price increases) and inflationary expectations that might prove very hard to control. On the fiscal side, worries about public sector debt sustainability mirror, and perhaps even exceed, those on the private sector side. Interest rates on many sovereign credits are already rising, and other countries might soon find themselves in the same situation. Faced with a rising sovereign risk premium, fiscal tightening could then be less damaging to growth than fiscal easing. The IMF has known this for years.

Suppose one were to accept this proposition that the repeated use of macro policies (never envisaged by Keynes) would eventually render them ineffective at best, or even counterproductive at worst. What other policy measures might then help deal with the debt headwinds problem? Two possibilities suggest themselves.

One possibility would be to try to make existing debt levels more sustainable. This could be done in two ways. First, encouraging an orderly deleveraging of

balance sheets, both household and financial, is one route. However, an obvious problem is that, as saving rates rise, multiplier and accelerator effects might interact to produce a much less orderly outcome than policymakers might like. To some extent, this global threat could be mitigated in current circumstances by higher investment in currently low saving countries (especially the United States) and higher consumption in currently high saving countries (especially China). However, such an outcome would have to be orchestrated to avoid exacerbating global trade imbalances. This would not be easy. Second, the capacity to service existing debts could be increased by structural policy measures to increase potential growth. A crisis commonly acts as a catalyst for such measures, and these should now be vigorously pursued. At best, however, both of the above attempts to make debt burdens more bearable will likely result in many years of much slower growth than we have become used to.

Another, faster, but initially much more painful way to make debt levels more sustainable is to reduce them. This could be done either through bankruptcies or “negotiated workouts”, with productive resources then being freed up for other uses. Evidently, this might also require the restructuring and recapitalization of the lending institutions as well. There are many impediments to this happening, particularly in countries (like the United States) where the debt problem affects many millions of households. In addition, justifiable concerns would be raised about the short term costs of higher unemployment, moral hazard, and property rights. Many countries also lack an adequate legal framework to facilitate such measures, particularly for financial institutions. Policy makers should make far greater efforts than is currently the case to try and remove these impediments.

Economics is often about hard choices. If the headwinds of debt overwhelm the effects of macro policies to stimulate growth, then other more structural measures must be turned to. Failing to muster the political will to do so, the greatest danger is that governments will pressure their central banks to inflate the debt away. There are many historical examples to prove it can be done, though few that stopped short of hyperinflation. Why take this very dangerous path when there are other paths to follow?