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We need a Plan B to curb the debt headwinds

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Policymakers have responded to successive economic downturns in essentially the same Keynesian way since the 1950s. Fiscal deficits have been allowed to rise and interest rates to fall to stimulate aggregate demand. Though Keynes hardly anticipated such repeated use of macro instruments, these policies have worked. As a result, the policy response to the current crisis has been "more of the same". Many policymakers remain confident that this will eventually generate a sustained recovery. Yet it is worth reflecting on why it might not work this time, and what other public policies might help foster recovery. In short, what is Plan B?

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. In Japan in the 1980s, corporations went on a similar spree of spending which was almost wholly funded by debt. However, the problem with debt is that it constitutes a claim on future earnings, which cannot be met if earnings expectations fail to materialise.

Although 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. The repeated use of fiscal measures to support demand made private debt more supportable, but also increased public debt levels. With respect to both monetary and fiscal policy, tightening in the cyclical upturns never matched the vigour of the easing in the downturns.

Both monetary and fiscal policies may now have reached the limits of their effectiveness. In monetary policy, interest rates ratcheted down and are now essentially at zero. In fiscal policy, worries about sustainability of public sector debt have caused sovereign rates to rise sharply in some smaller countries; and other, bigger, countries might follow. Faced with the prospect of a rising sovereign risk premium, fiscal easing will prove less supportive of growth than fiscal tightening. The International Monetary Fund has known this for years.

If the repeated asymmetric use of macro policies has rendered them ineffective, what other policies might help deal with the debt problem?

One possibility would be to try to make existing debt levels more sustainable. Encouraging an orderly deleveraging of balance sheets, both household and financial, is one route. But as saving rates rise, multiplier and accelerator effects might interact to produce a much less orderly outcome than anticipated. Another way to raise debt service capacities would be to increase potential growth through structural reforms. Since a crisis commonly acts as a catalyst for such reforms, they should now be pursued vigorously. At best, however, both routes would seem likely to produce many years of very slow growth.

A second, 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 being freed for other uses. It might also require restructuring and recapitalisation of lending institutions. Again, there are many impediments, particularly in countries (such as the US) where the debt problem affects 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 the legal framework to facilitate such measures, particularly for financial institutions. Policymakers should try much harder than they currently are to remove unnecessary impediments to an orderly writing down of debt.

Economics is often about hard choices. If the headwinds of debt have overwhelmed the capacity of macro policies to stimulate real growth, then other, more structural, measures must be turned to. Failing to muster the political will to do so would increase the likelihood of an inflationary solution to the debt problem. There are many historical examples to prove this can be done, though few that stopped short of hyperinflation. Why take this very dangerous path when there are other less dangerous paths to follow?

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