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The fallacy of sustaining dysfunction

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INSIDE THE MARKETS

The global economy faces a huge reallocation of capital, resources and employment — a process that will take years and that is being harmfully delayed by current policies.

As it has in every period of economic or financial stress in the past 20-odd years, monetary and government policy has concentrated on easing conditions to stoke demand. But the policies that shape the economic landscape have tried, with few exceptions, to keep obviously overgrown industries like housing, automobile manufacturing and finance from shrinking.

But shrinking is exactly what huge swaths of the global economy almost certainly need to do. So huge have been the interventions — the U.S. support for housing and China's cap on its currency — that we really have very little idea what the "real" economy, if such a thing can be said to exist, actually looks like.

"What do we know about aggregate demand?" William White, chairman of the Economic and Development Review Committee of the Organization for Economic Cooperation and Development, asked at a conference in February organized by the Reserve Bank of India. "The answer at the moment is virtually nothing," he said, because of the effects of the unprecedented government programs to prop up demand.

We may have reached the limits of falling interest rates and rising levels of debt.

"Nobody is talking about the supply side," he said.

Mr. White criticized the cash-for-clunkers car-purchasing program in the United States, where household consumer spending accounted for 80 percent of gross domestic product at its peak. "This is madness," he said.

"Short-time working in the auto industry in Germany when those jobs will never come back? Holding down the exchange rates in China to keep export jobs still functioning when we all know that longer term this is not going to be sustainable?"

Mr. White, a former chief economist at the Bank for International Settlements, has argued convincingly that successive interventions by central bankers, led by the U.S. Federal Reserve, seeking to cushion fallout from one bubble or another, have simply led to further distortions in the economy and, as the Austrian school of economists would put it, "malinvestment."

The great debate now is whether this asymmetric policy — cushioning on the way down but not blocking on the way up — can be succeeded by a policy where central banks exert pressure on asset prices as they inflate.

It is not a matter of central bankers' knowing the "right" price for an asset but of controlling the amount of credit being created, as they should.

Outsiders can, of course, talk until they are blue in the face about the policy we ought to have, but perhaps more interesting is what will happen because of the policy we are going to have to live with.

There seem to be three alternatives as to how this will work out.

Those responsible for current policies argue that they are the right path, that they will ease a transition to a differently shaped global economy, with less consumption in the West and more in Asia, and that the alternative to keeping alive a failed model was too dire.

The second alternative is that the current policy is the wrong policy precisely because it will work. The current mix of fiscal and monetary stimulus will reignite some bubble that will distract us from our current problems, lead to re-employment and strong economic growth and bite us only when the new bubble explodes five years or so down the line. That explosion would be worse because the buildup of debt will be greater.

The final alternative is that the current policy is the wrong policy and that it will not work. We may have reached the limits of effectiveness for a set of policies that depends on falling interest rates and rising levels of debt to artificially drive demand. We may finally have arrived at the place Japan reached long ago. Low interest rates and quantitative easing may simply not be all that effective when both borrowers and lenders realize it is in their interests to trim sails.

Or a sovereign debt crisis may show that we have reached the point where the creditors will no longer play their assigned role.

That, rather than euro-zone pantomime, is the most interesting angle on the Greek debt crisis.

James Saft is a Reuters columnist.