Things keep getting worse: Time for a total reset?

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Introduction

The financial and economic crisis, which began in 2007, was a point of systemic rupture when the proverbial chickens came home to roost. It was not a one-off event, resulting primarily from new and untested lending practices, though clearly these also made a contribution to the carnage. Rather the crisis was the inevitable result of a cumulative process, stretching back decades. Accepting this fact has important implications for how we ought to conduct global economic policy in the future. Indeed, it suggests the need for a total reset. Instead of successive short term "fixes," we need policies designed for the longer term. In this essay, I will speculate on some of the changes required in the policy framework to produce the "strong, sustainable and inclusive growth" desired by the G20.[1] Pursuit of these objectives has political implications as well.

Prior to 2007 central banks had, for decades, pursued short term policies designed to eliminate perceived shortfalls in aggregate demand and to avoid the immediate dangers of financial crisis. In successive critical episodes – 1987, 1990, 1997, 1998 and 2001 – the policy response was to reduce short term interest rates with ever increasing forcefulness. Since policy rates were never raised symmetrically in better times, they eventually ratcheted down to the Zero Lower Bound (ZLB). Still more important, the longer run and unintended consequences of these policies tended to be completely ignored. Not least, there was a continuous and cumulative increase in both private and public debt levels and many financial and economic "imbalances."

By 2007, however, the "headwinds" of debt and leverage had become overwhelming and the crisis began. It originated in the sub-prime mortgage market in the United States, but could have begun anywhere. Having quickly (and rightly) acted rather conventionally to stabilize financial markets,[2] central banks subsequently responded to persisting weak demand with such unconventional policies as quantitative easing, forward guidance and even negative interest rates. In a fundamental sense, however, they were simply "more of the same" policies that had preceded the crisis. They were premised on the belief that monetary easing would succeed in supporting short term aggregate demand and that the longer-term consequences could continue to be ignored.

Fiscal policy has been conducted with a similar, short term orientation. In downturns and financial crises, both automatic stabilizers and discretionary stimulus resulted in big increases in government deficits. However, in better times, government surpluses never rose as sharply as the deficits had previously. As a result, government debt levels also ratcheted up over time. Associated with these developments was a clear change in mind set which discouraged thinking about such longer-term implications. In earlier times, the presumption was that governments would pay down debts in anticipation of future crises;

[1] Deserving a second essay is the question of the transition from the current path to a better one. A central problem will be dealing with the current, dangerous overhang of debt, both public and private.
[2] Central banks pushed rates down to the ZLB and also made massive purchases of securities, albeit with different central banks doing so in rather different ways.

wars and natural calamities, for example. However, increasingly, the only fiscal constraint was seen to be the maintenance of market access so that debts could be renewed when they came due. The loss of such access by a number of European countries in 2010, some of whom had actually been relatively disciplined, showed the potential dangers of such thinking.[3]

Financial regulatory policies have also suffered from a failure to appreciate the future implications of current policies. The fundamental problem is that the short-term liabilities of banks are commonly thought of as "money." Banks therefore can create leverage by simply writing up both sides of their balance sheet, and historically have often done so excessively. Leverage, however, makes the banks subject to "runs" which leads the financial authorities to introduce safety nets of various kinds; deposit insurance and lender of last resort facilities. The moral hazard associated with this seems to call for the regulation of banks, which indeed has been increasing almost everywhere since the 1990s. However, this had the unintended consequence of increasing evasion and this in turn led to the "shadow banking" crisis of 2008. The post crisis tendency to extend the border of regulation threatens the risk of forcing finance still further into the unregulated shadows in another dangerous and never-ending dynamic.

Since the crisis, the interactions between the policies followed have also led to unintended consequences. Monetary policy, for example, has had its foot firmly on the accelerator while the regulatory foot has been firmly on the brake. To the limited extent that each agency has thought about the implications of the other's policies, the conclusions reached have been dangerously benign. Regulators seem to presume that expansionary monetary policy will succeed in restoring "normality" even in the face of their own tightening of regulations. Worse, this assumption has reduced the urgency of governments finally resolving financial crises through debt restructuring and the explicit recapitalization of financial institutions. Similarly, monetary policy assumes that regulatory changes will suffice to prevent future financial crises. Thus, central banks could ignore the further, massive build up of debt encouraged by their own policies in the post crisis period.[4]

If the crisis of 2007 is viewed as the inevitable outcome of long standing policies, and the policies since 2007 are viewed simply as "more of the same," only one conclusion logically follows. We are on an unsustainable and increasingly dangerous economic path. Moreover, the rise of populist sentiments in many countries, in part a response to non-inclusive growth, implies we might well be on a dangerous political path as well.

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[3] It also led to a rather panicked attempt to restore fiscal discipline in the advanced market economies, especially in the euro zone, at a time when aggregate demand growth was still weak. This implied still more pressure to ease monetary policy as "the only game in town."

[4] The IIF estimates that global non-financial debt (households plus corporations plus governments) rose by $70 trillion over the last ten years to a current level (end 2016) of $215 trillion or the equivalent of 325 per cent of global GDP. This implies that the process of deleveraging, which typically accompanies the "bust" following a credit "boom" has not yet even begun. Further, much of this new debt has been accumulated in emerging market economies, not least in China, with infusions of foreign credit by asset management firms being a new variation on an old theme. The upshot is that, while expansion in emerging markets was part of the solution to the crisis in advanced market economies in 2009, emerging markets are now part of the problem.

Three things need to change in the policy framework? First, we need to respond to an "analytical deficit." We need more Schumpeter (supply side policies) and less Keynes (demand side policies) in deciding what economic policies should be implemented. Second, we need to respond to an "executive deficit." The institutional structures that currently condition policymaking, both nationally and internationally, are inadequate. Finally, there is a third shortcoming, a "democratic deficit." Policy options that are both needed and practically possible might not have the popular support required for implementation in democratic societies. Evidently, dealing with all these deficits[5] will not be easy.

<A>An analytical deficit

Virtually all the models used by economists assume that the operations of the economy are like those of a machine. It is essentially static and therefore both understandable and controllable.[6] These models need to be replaced by others which assume, in sharp contrast, that the economy is more like a forest. It is constantly evolving and therefore neither fully understandable nor controllable. In the jargon, the economy is a complex, adaptive system like many other such systems in both nature and society. Fortunately, other disciplines have been studying such systems for a long time and macroeconomists could learn a great deal from existing knowledge. As will be documented below, the simple embrace of the concept of "complexity" provides many insights as to how we might more successfully pursue strong growth, sustainable growth, and inclusive growth.

<B><u>Strong growth</u>
The first consequence of embracing complexity is that the emphasis shifts from the demand side of the economy to the supply side. While tight control over demand is not possible at any moment in time, it is still possible to nurture the development of the economy over time. Structural reforms to ensure the easy entry and exit of firms is crucial to support an evolutionary process. So too are reforms to ease the reallocation of factors of production from less efficient to more efficient uses, not least the reduction of employment protection legislation (EPL). Unfortunately, there is growing evidence that, in many respects, we have been going backwards in these areas in recent years.

To put this another way, we need to develop an economy which is more resilient to supply side shocks. Globalization and the introduction of value added chains constitutes a recent such challenge which has not been well met in the advanced market economies. Looking forward, the principal challenge seems likely to be the introduction of new technology (robots, artificial intelligence etc.) which could dramatically increase productivity while hollowing out the jobs market, particularly for the semiskilled. How policy might respond to the plight of those most affected is discussed below under "Inclusive growth."

<B><u>Sustainable growth</u>

[5] Nicolas Veron of the Bruegel Institute has previously referred to these three "deficits" in writing about the Eurozone. I have referred to them in other publications as the "should, could and would" problems.
[6] The former attribute reflects a whole host of unrealistic assumptions, not least the unimportance of financial developments and cumulative processes. The latter reflects the view that the economy has a natural tendency to converge to full employment, which can be complemented by effective policies of demand management.

Another implication of embracing complexity is that systemic breakdowns (or crises) are regarded as inevitable. Moreover, the associated literature suggests that the amplitude of such disturbances is inversely related to their frequency, according to a Power Law. This has a number of implications.

First, if crises are possible, it becomes a totally legitimate question to ask whether activist demand management policies actually contribute to instability, as suggested above. If so, perhaps the objective of such policies should shift from maximizing the short-term level of GDP (efficiency) to some combination of efficiency and sustainability. In the limit, a minimaxing objective that seeks to avoid bad outcomes might be recommended. This way of thinking would seem to argue for more symmetric monetary and fiscal policies as well as a greater tolerance for small downturns. The latter would help prevent the cumulative build up of the dangerous "imbalances" that led to the 2008 crisis and would also support the Schumpeterian process of "creative destruction."

Second, if crises are inherent to the economic system, then policymakers should be prepared for them. This involves both taking steps before, to facilitate crisis management, and then actually intervening after the crisis has begun. Some aspects of the Dodd-Frank act imply the Fed's capacity to do this in the future will be much reduced. Moreover, if similar constraints prevent the Fed from supplying dollar funding to financial institutions that require such funding, the implications would extend far beyond the United States.

Third, the complexity literature suggests that the "trigger" for a crisis could be anything. Policymakers should therefore rather focus their attention on indicators of growing systemic instability. Given the presumption of complexity and multiple possible "triggers," it also seems unlikely that a single-minded focus on inflationary pressures is likely to be sufficient to identify all emerging threats to economic stability.

Fourth, in complex adaptive systems, problems will always arise in unexpected corners. Evidently this has implications for macroeconomic policy makers, but perhaps even more so for regulators. Ever more detailed regulations, designed to prevent the recurrence of old problems, positively invite evasion and the creation of new problems. The implication would seem to be a greater reliance on the self-interest of market participants and on market discipline as an alternative to regulation.

Finally, in complex adaptive systems the future is essentially unknowable. This implies that policymakers should rely less on forecasts and more on alternative scenarios, each implying the need to prepare an appropriate policy response. This statement also implies that what the future promises is not "risk" but rather what Keynes and Knight called "radical uncertainty." If so, then current estimates of the buffers (both fiscal and regulatory) required to deal with tough times are likely to be seriously underestimated.

<B>Inclusive growth

Treating the economy as a complex, adaptive system implies that it is the interactions of many different microeconomic agents that determines overall macroeconomic performance. Given such a view, world, distributional issues really matter. They can affect

both the demand side and the supply side of the economy, thus having the potential to put the economy on a different evolutionary path.

On the demand side, Rajan (2010) has suggested that a growing concentration of income and wealth in the hands of the richest in society can lead to chronic under consumption. In turn, this increases both the likelihood of increased monetary stimulus to offset this shortfall, and the likelihood that such stimulus will not work as intended. This way of thinking implies that our current difficulties stem, in part at least, from underestimating the importance of distributional issues.

On the supply side, shocks (global or technological) that increase productivity will commonly put some groups of people out of work. The real policy challenge is to facilitate their finding new and rewarding jobs afterwards. This implies safety nets for individuals that are generous enough to allow time for retraining and job choice, but not so generous as to reduce the incentive to work. Governments also need active labour market policies that combine both carrots and sticks to encourage a return to meaningful work. Such policies are something of a magic bullet in that, by encouraging inclusive growth, they also contribute to growth being both stronger and more sustainable.

<A>An executive deficit

Economic developments and the need for economic reforms might also imply the desirability of political reform to "make change happen."[7] Two, important, longer term economic trends have been urbanization and globalization. Taken together, they increasingly call into question the model of the nation-state, first established by the Treaty of Westphalia at the end of the Thirty Year War in 1648. On the one hand, concentration of power at the level of the nation state constrains the capacity of city governments to respond adequately to the needs arising from urbanization. On the other hand, it also ensures that governance at the global level is inadequate to cope with the requirements of globalization. What then seems required is a "barbell" shift in the locus of power, towards both the sub-national and supra-national levels.

Absent sufficient power to act, city governments will find it hard to provide adequate planning and infrastructure to cope with a growing number of citizens. As well, they will find it hard to do their part to deal with such global challenges as climate change, terrorism, restraining pandemics and inequality, especially that arising from inadequate access to affordable housing. At the least, metropolitan governments must have the power to ensure coordination among subordinate municipalities.

Similarly, inadequate global governance implies rising threats to international macroeconomic stability. We currently have an International Monetary Non-System in which each large country can pursue its own short-term interests without regard to the effects on others (spillovers) or the longer run implications (unintended consequences). Massive, competitive increases in the size of the balance sheets of the world's major central

[7] In pursuit of this objective, the OECD has undertaken a significant amount of research into the political economy of change.

banks are totally unprecedented and potentially quite dangerous. Nevertheless, they have been met with no resistance from any supra-national source.

<A>A democratic deficit

Beyond a certain point, almost impossible to predict beforehand, rising inequality has political as well as economic implications. It violates an innate sense of “unfairness” and leads to popular discontent and declining “trust” in the current government. There is a growing historical literature indicating that financial crises are often a trigger, revealing such sentiments that were previously supressed.

In the aftermath of a financial crisis, voters tend to reject the centre and polarize between those espousing the need for a more national approach (nationalists) to policy making and those espousing the need for more government control (socialists). In the former case, and historically the more likely outcome, immigrants, foreigners and traditional scapegoats tend to be blamed for ongoing problems. Moreover, as Hayek (1946) reminded us in “The Road to Serfdom,” both poles can unite (to form the National Socialists) with a devastating impact on democracy itself.[8]

Many recent developments are consistent with this narrative. Consider the outcome of the Brexit referendum, the election of President Trump, the effective disappearance of the two mainline parties in the Presidential elections in France, and recent developments in Korea. Consider too what the political implications might be should a financial crisis hit China. While there seems to have been a welcome retreat from “populist” sympathies in France and Germany recently, a failure of new governments (including the Trump administration) to deal with the underlying causes of resentment could lead to a still stronger backlash in future elections. In short, we are as exposed to political instability today as we are to economic instability.

What might be done differently? Regarding widening domestic inequality, various “worker friendly” policies should be investigated. Could wages be allowed to rise without sparking an inflationary spiral? Record high profit spreads seem to point in this direction. Could more aggressive competition laws and enforcement levels bring prices and profits down? This would not only benefit ordinary people economically but would help reduce the political power exercised by those currently receiving monopoly rents. Could all the policies for supporting inclusive growth, suggested above, work in the same direction? Pushing all these issues higher up on the policy agenda, accompanied by concrete follow-up, would help restore a sense of fairness and the trust in government that arises naturally from it.
As for misguided popular perceptions about globalization, a great deal could also still be done. Governments should make the positive case for globalization, not least lowering consumer prices for the poor. Focusing solely on the negative effects of withdrawing from global processes is unlikely to be adequately persuasive; think of the Brexit campaign. As well, it should be much more widely publicized that the real threat to jobs has not been globalization but technology. Governments should indicate clearly that they are collectively working on how to deal with this problem in a “socially just” way, as suggested above.

[8] The nationalist cause has more to do with the objectives of policy, and the socialist cause more to do with the means of achieving those objectives. Thus it is not hard for both causes to combine.

Again, a government commitment to ensure that technological advances benefit the many, and not just a few, would enhance both a sense of fairness and of trust in government itself.

<A>Conclusions

As suggested above, many evolutionary steps are possible in both the economic and political spheres to improve global economic policies. Policymakers should be getting on with them. However, some thought might also be given to some more revolutionary suggestions in the economic sphere, in particular the nature of our monetary arrangements. Changes at both the domestic and the international level might well be contemplated.
At the domestic level, credit excesses leading to financial crisis ultimately have their roots in the capacity of banks to create money. Moreover, non-banks increasingly offer deposit facilities which seem to have money-like characteristics (totally safe and liquid) until a crisis falsifies those assumptions. Renewed interest in the "Narrow Money" proposals of the Chicago School in the 1930s is welcome, although these proposals need to be brought up to date to reflect the increasing fungibilty of "money." A recent book by Jonathan MacMillan (2014) does just that. It shows how the Fin Tech revolution provides the promise of stabilizing financial alternatives to the essentially destabilizing services (especially money creation) provided by the current domestic financial system.

At the international level, the current Monetary Non-System also needs to be rethought. Support for the current approach rests on a number of widely held beliefs. Most important, floating exchange rates will automatically adjust current account imbalances and avoid "spillovers" from one country's policies to another. As well, floating plus the pursuance of domestic price stability ensures the avoidance of international financial crises and obviates the need to prepare for them. Unfortunately, recent empirical evidence increasingly indicates these beliefs are false. A recent book by Robert Pringle (2012), provides a useful starting point for thinking seriously about these important monetary issues.

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