A New Reading of the Crisis and the Dilemmas of Economic Policy (ARI)

Federico Steinberg[*]

Theme: The financial shock waves of August 2011 call for a review of the diagnosis of the crisis and an evaluation of the limited economic policy alternatives at the disposal of the US and the euro zone.

Summary: This ARI argues that in order to understand the turbulence that has rocked the international economy since August 2011, it is necessary to re-diagnose the crisis. It explains that the economic growth posted by most advanced countries (excluding Spain) in the wake of the recession of 2008-2010 was in part just a mirage, fuelled by government stimulus measures that are difficult to maintain. The paper also examines the limited economic policy options that governments have.

Analysis:

Introduction

Just when it seemed that economic recovery was consolidating and the Great Recession of 2008-10 was being left behind, the financial markets against suffered acute volatility in August 2011. Even though in late July the countries of the euro zone reached an agreement designed to stabilise the debt crisis and the US managed to raise its debt ceiling so as not to slip technically into default, stock markets on both sides of the Atlantic collapsed and spreads on Spanish and Italian bonds hit record levels. In the euro zone it took bond purchases by the European Central Bank to calm things down, although the relief was only temporary. In the US, after Standard & Poor's made its controversial decision to downgrade the US debt rating, fears of another recession spread, and the contagion has hit stock markets in emerging economies. In this new context of uncertainty, in which it is impossible to know if the risks involve inflation or deflation, gold and bonds from the soundest countries have served as havens for investors. As gold has soared to historic levels of around US$1,900 an ounce, the yield on the debt of countries considered safest (including the US and Japan, which do not have an AAA rating) has fallen to nearly 2%. That automatically raises the spread on the debt of countries of the euro zone's periphery. To sum up, all of a sudden investors have changed their perception of the international economic reality and are shunning practically all forms of long-term investment.

The main problem that the world economy (especially advanced countries) is facing is that it must confront this new crisis practically without economic policy tools and with nil political consensus on what path to follow. After the collapse of Lehman Brothers in

[*] *Senior Analyst for International Economy and Trade at the Elcano Royal Institute and Lecturer at Madrid's Universidad Autónoma.*

September 2008, there was room for fiscal and monetary stimulus measures. But these days, interest rates are already very low and most countries cannot bear any more public debt, especially on the euro zone's periphery. But what is even more worrying is that whereas in 2008 the international community acted in a coordinated fashion under the leadership of the G-20 by rescuing the financial system and activating unprecedented mechanisms to stir demand, today there is little scope for international cooperation. This is because the main powers are wrangling with their own domestic problems, a situation that raises the risks of another currency war and escalating protectionist barriers, besides making it harder for markets to regain lost confidence. In the US, which is suffering from a high unemployment rate and does have room to boost public spending, a dialogue of the deaf between Democrats and Republicans is blocking any kind of political initiative and allows only the Federal Reserve to act. But the US central bank's room for manoeuvre is limited because the economy could find itself in a liquidity trap, a scenario in which monetary policy is not effective. In Europe there is also sharp clash between the German explanation of the euro crisis –pointing to a lack of discipline and productivity in the countries of the south– and the rest of the EU, which insists that only an overhaul of euro-zone governance in the direction of a fiscal union will make the single currency viable. Although slowly, progress is being made towards a new pact under which the countries of the periphery will 'Germanise' their economic policies in exchange for German transfers (not real ones, but rather in the form of an increase in the credibility of their fiscal policies thanks to German support, ultimately through the issue of eurobonds). But while the details of the accord are being negotiated with difficulty, only the ECB can stabilise markets and it seems willing to do so only under extreme circumstances. Finally, the emerging countries, which have posted robust growth since 2010, are worried about the prospect of their economies overheating, about inflation and about the possible adverse effects that an economic slowdown in advanced countries might have on their exports.

This ARI argues that in order to understand the current turbulence in the international economy it is necessary to make a new diagnosis of the crisis. The economic growth posted by most advanced countries (excluding Spain) in the wake of the recession of 2008-10 was in part just a mirage, In 2008 a collapse of the financial system was averted by a huge injection of government money. This gave rise to a major increase in public debt in advanced countries, but did little to chip away at private sector debt. Therefore, in the current context the financial system is far from having recapitalised itself, companies struggle to obtain financing (in addition to being reluctant to invest and create jobs because prospects for economic growth are slim) and stock markets have been 'subsidised' by the quantitative-easing monetary policy of the Federal Reserve. This makes for a situation of severe weakness, in which events like a rise in oil prices, geopolitical tensions in the Arab world, the deepening debt woes of the euro zone or news of fiscal contraction in the US can touch off a wave of selling on financial markets and create volatile situations that are difficult to contain. But as Reinhart and Rogoff show in their history of financial crises (*This Time is Different*: *Eight Centuries of Financial Folly*, Oxford University Press, 2009) this is the usual scenario after a crisis caused by a bubble financed with excess debt. In order to return to growth what is needed is to reduce debt levels, especially those of financial entities and the most debt-laden companies and countries which have reached levels of debt that are unsustainable. And that takes time, unfortunately. It can be sped up only by renegotiating (or not paying) debt and by increasing inflation.

What Scenario are we Facing?
The financial turbulence of August 2011 was particularly worrying because it took investors, politicians and analysts by surprise. The debt woes of some euro-zone countries aside, the dominant feeling about the crisis had been that the worst was over. Few people expected a new spate of financial panic, especially as the US economy was growing. Specifically, this narrative –that served as a conceptual framework for interpreting the evolution of the international economy– held that the world had been able to avoid a second Great Depression thanks to the monetary and fiscal stimulus measures that were quickly enacted and in a coordinated manner after the bursting of asset bubbles in 2008. Memories of the crisis of the 1930s allowed high levels of international cooperation which saved the financial system, prevented a rise in protectionism and led to regulatory reforms that would facilitate growth that was more sustainable.

Therefore the recession, although it was long in comparison to cyclical drops in production over the past 25 years (known as the period of 'Great Moderation' in macroeconomic terms), was not devastating. The main industrialised countries returned to growth in 2010 and emerging economies suffered only a slight drop in production. Although in countries in which real estate bubbles burst (the US, the UK, Spain, Ireland, etc) unemployment rose sharply, economic activity normalised by the time 2011 came round. The CEO of the investment fund PIMCO, Mohamed El-Erian, coined the phrase 'new normality' to refer to the new model of growth the world would have to get used to in the wake of the crisis. In this 'new normality', the rise in production and income would be less pronounced than in the period 2002-07. But countries would not endure frequent recessions, periodic bouts of high volatility in financial markets, debt crises or social unrest.

Some critics said this reading of the crisis was too limited. Krugman and Stiglitz called for greater monetary and fiscal activism in advanced countries so as to reduce unemployment more quickly, while Roubini warned that the financial system remained too highly leveraged, so the risk of new recessions was not insignificant.

But perhaps the most accurate diagnosis of the problem facing the world economy has come from analyses done by Reinhart and Rogoff, mentioned above. These authors showed in their study of more than 800 years of financial crises that recessions caused by collapses which end periods of heavy indebtedness are much longer than the cyclical recessions that occur when central banks raise interest rates because of inflationary risks (whereas cyclical recessions rarely last more than six months, after a financial crisis breaks out, on average real estate prices fall by 36% and take five years to recover, stock markets drop by 54% and climb back in three-and-a-half years, unemployment grows by 7% and takes five years to fall again and per capita GDP declines more than 9% and takes two years to recover).

Therefore, in this kind of crisis, which is rare at the global level but especially long and harmful, recession –which authors prefer to call a contraction to distinguish it from cyclical recessions– goes through various phases. At first there is a major accumulation of debt (generally private, although sometimes in the public sector as well) fuelled by excess credit and under-evaluation of risk, which triggers bubbles in the stock and real estate markets. When the bubble pops, the government deficit increases, both to 'rescue' the financial system and through automatic stabilisers (lower tax revenue and higher spending on unemployment benefits). Then the deficit transforms into growing public debt, in some cases simply because of increased spending and in others because private losses ripple through society by means of rescues of the financial sector. Finally, the high level of public debt leads to a downgrading of countries' debt rating, which limits their capacity to finance themselves and can lead to situations of default.

This cycle of the four D's –debt, deficit, downgrade and default– drags on for several years, during which market episodes of market upheaval repeat themselves. Therefore, even if GDP grows, it is impossible to speak of recovery because the persistence of unemployment and poor prospects make the overall perception one of stagnation. What is more, as Rogoff has argued, the measures usually taken against recession (monetary and fiscal stimuli) are not a good solution against this kind of contraction because sustainable growth, investment and job-creation do not return until the financial system, companies and households have shed enough debt and excess supply (as in unsold homes or un-used investments) has been reduced.

Bearing in mind that the financial crisis of 2008 was the most severe since the Great Depression, the prognosis of these authors suggests that it will take years for things to get back to normal and that the period of debt-reduction will have many rough patches. Furthermore, the GDP growth and the stock market rises seen since 2010 in advanced countries, rather than being sustainable, have been fuelled by extended monetary and fiscal stimulus packages (mainly in the US) that have probably done nothing more than delay the necessary adjustment that economies have to endure during the painful period of de-leveraging (growth in emerging countries has in fact been sound because they have not gone through financial crises or increases in indebtedness; rather, they have suffered from contagion; but these countries on their own cannot yet drive the world economy).

In this context, the turbulence of the month of August 2011 must be viewed as the kind of bump that happens when politicians' inability to confront in a satisfactory way problems linked to a lack of growth and/or excess government debt trigger panic in the financial markets, that remain bullish artificially thanks to monetary stimuli (and bearing in mind that all of this is happening in a situation of high prices for oil and other commodities and geopolitical tensions in the Arab world, which raise the risk of a supply shock that might make the process of debt-reduction even tougher).

In the case of the US, the Federal Reserve's announcement that it would not launch another programme of quantitative monetary expansion after the one that ended in July 2011 –along with the prospect of fiscal contraction over the medium term because of the lack of political consensus in Congress and the President's almost absent leadership– led to a market drop that heralded a possible double-dip recession (other contributing factors were the lowering of the US credit rating and the downward revision of US economic growth figures for previous years, which showed that expansion had not been as strong as it had seemed.)

In the euro zone, investor panic and massive sales of Spanish and Italian debt came when markets interpreted the Eurogroup accord of July 2011 –which accepted a partial Greek default that could be extended to Ireland and Portugal– as possibly meaning that Spain and Italy could no longer make their debt payments. The accord reduced the interest rate Greece would pay on its bailout loans to 3.5%, while Italy and Spain were paying more than 5% for financing on the open market. The math speaks for itself: if the latter helped their troubled neighbours (not directly but rather through their contributions to the European bailout fund) they would jeopardise their own solvency. Naturally, the reaction was a sell-off of government debt. At the same time, when it became clear that the rescue fund would not have enough money to bail out Spain or Italy, French stocks markets suffered steep falls. Why? If France had to chip in extra financing to the rescue fund, it could be calling its own financial self-sufficiency into question.

Indeed, in order to comprehend the financial turbulence and downward revisions of growth forecasts for advanced countries in the summer of 2011, it is necessary to re-diagnose the crisis. Given the high levels of debt that exist, the tepid recovery of the past year is not sustainable and both the US and Europe run the risk of falling into the period of prolonged stagnation experienced by Japan after the bursting of its real estate bubble in the 1990s. In that situation, deflation dragged the contraction out even more. In this context, can economic policy achieve anything?

Economic Policy Options

Under the diagnosis laid out so far, what advanced economies need is time to digest their mountains of debt. At the same time, it is essential to prevent economic stagnation, lack of investment, consumption and employment from turning into deflation, as falling prices increase the real value of debt, rather than reduce it. But the economic authorities are faced with several problems.

First of all, they are saddled with major monetary and fiscal restrictions which they did not have at the outset of the crisis. There is hardly any scope at all for conventional monetary policy (decreases in interest rates) and only some countries, such as the US and Germany, have leeway to activate new stimulus packages. Secondly, as such a situation has not been experienced since the Great Depression, there is a high degree of uncertainty as to what the effects will be of new demand-expanding policies in a context of high government debt and interest rates that are close to zero (structural reforms, which will allow to increase growth over the long term, will have limited effectiveness until demand rises again, so in and of themselves they will not solve the problem.)

On the monetary side, both the Federal Reserve and the ECB can inject more liquidity through non-conventional quantitative expansion operations (printing more money to buy bonds). But it is not really known if this will cause a dangerous, inflationary spiral, although it will in fact undermine the credibility of the monetary authorities and shift money from creditors to debtors, something which is hard to justify in terms of justice and fairness. Therefore, countries that are creditors and traditionally wary of inflation, such as Germany, oppose the ECB buying bonds. This means that, although the ECB might stop raising interest rates if growth in the euro zone slows down, it will probably only buy government debt when markets exert unbearable pressure on peripheral countries, and not as a large-scale stimulus programme as the US has been doing for the past three years.

On the other side of the Atlantic, those who accuse the Fed of being among the culprits of the crisis for following a monetary policy that is too lax are also opposed to the idea of new monetary stimuli. There is a difference of opinion even within the US central bank itself. Some officials support a third wave of quantitative easing while others are reluctant, either out of fear of inflation, or out of the belief that it will not work because the economy could find itself in a liquidity trap (a situation that happens when a monetary injection fails to stir investment and consumption because expectations are so low that both businesses and consumers prefer not to spend their money). For now, the Federal Reserve has only said it will keep interest rates very low until at least 2013. But it will probably approve new stimulus measures in the future if the risks of deflation increase.

On the fiscal side, all countries must enact austerity programmes over the mid-term so that their debt levels will be sustainable, but to the extent that they can, they should avoid doing so too quickly so that the fiscal contraction will not trigger another recession. Countries that still have room to go further into debt because they have credibility on the international markets can take the risk of launching new fiscal stimulus measures over the short term to reactivate demand. That said, there is the risk that the financial markets will view this new spending as putting public finances in an unsustainable position, and demand higher interest rates for buying debt or withdrawing financing altogether, as has occurred with Greece, or could possibly happen even in Spain and Italy. These are the so-called non-Keynesian effects of fiscal policy: rather than generate a virtuous cycle of growth that ends up reducing debt, an increase in government spending prompts adverse expectations that spook investors and force a hasty fiscal contraction.

If in the end new fiscal stimuli are approved, the spending should be earmarked for activities that raise capital levels and economic productivity over the long term, not for rises in current spending. All signs are that the US could enact a plan to modernise its antiquated infrastructure network. But in Europe it is unlikely something like this will be undertaken, because of resistance from Germany, which has already begun the process of fiscal contraction and hopes to serve as a model of austerity for its fellow members of the euro zone. All told, the countries that would like to increase government spending cannot do so, and those that could do not seem to want to, or face huge political difficulties that stand in the way.

Finally, as each country is in a different situation (emerging ones have little debt but risk overheating and the advanced ones have varying degrees of leeway to launch new stimuli) achieving international cooperation is tough. What is more, domestic economic problems centred on high unemployment and social unrest –along with the belief that the international financial system is no longer on the verge of collapse as it was in 2008– are causing international leaders to put international cooperation on the back burner and to adopt unilateral measures that can trigger new international economic conflicts by producing negative externalities. In particular, another wave of monetary expansion in the US could unleash another currency war because much of the liquidity that the Fed could put into circulation would end up flowing to emerging countries which offer better investment opportunities, causing their currencies to appreciate.

All in all, although economic policy options do exist, each alternative carries with it a high degree of uncertainty because no one knows how the economy or markets will react. In order to trim excess debt you need growth. But many growth-oriented policies generate new debt, making for a vicious cycle that is hard to break. At the same time, speculative attacks in the markets against the debt of the most vulnerable countries are caused both by excessive debt and low growth prospects. That makes it hard to design austerity measures that really serve the purpose of instilling confidence.

It is possible to adopt more radical measures to speed up the essential process of reducing debt. But from a political standpoint they are hard to carry out and raise serious problems regarding who is made to suffer.

First, inflation could be triggered to reduce the real value of debts, which would punish (careful) creditors and benefit (irresponsible) debtors. In order to achieve this, central banks would have to explicitly set a high inflation target (for instance, 6%) and commit to injecting liquidity indefinitely until this level is achieved (another, even more drastic possibility would be for central banks to set a target directly linked to nominal GDP growth). This would amount to a definitive abandoning of monetary orthodoxy and giving up the anti-inflation credibility that central banks have built up since the 1970s. Critics of this sort of initiative say there is risk that inflation would enter an upward spiral that would take it far above the set target and be hard to curb, and that debts indexed to inflation would not change. It would be hard for the ECB to opt for this alternative because under its charter it is supposed to keep an eye on inflation, rather than growth. However, the Federal Reserve might gradually move in this direction.

Secondly, it would be possible to force through a renegotiation of those contracts in which the debtor will not be able to keep up with payments; in other words, speed up bankruptcies (business and personal) and defaults (by countries) when it is clear this is going to happen sooner or later. This would allow cleaning up balance sheets, make it easier for credit to flow again and lighten the debt load of countries drowning in it, although it would be enormously costly for those who suffer capital losses. The problem is that, in most cases, these are private contracts in which there is no clause allowing renegotiation until a situation of bankruptcy is reached –something which both the creditor and the debtor try to put off as long as possible because of the adverse consequences it entails for both–.

Conclusion: After a short period of growth, industrialised countries again face the risk of recession. This means the world economy is still far from overcoming the aftershocks of the financial meltdown of 2008 and that the recovery which began in 2010 was based on monetary and fiscal stimuli, not on a recovery of private demand. Europe and the US are right back in a new phase of what Reinhart and Rogoff have labelled the second Great Contraction (the first was in the 1930s), characterised by government debt woes stemming from the hangover from the financial collapse of three years ago. As long as debt levels of companies, households and governments do not come down, growth is likely to be limited, unemployment persistent, financial market volatility high and inflationary risks recurrent.

In this context, the available instruments of economic policy are limited, and there are major political difficulties when it comes to using them. Over the short term, it would be good for those countries which can afford it to adopt new fiscal stimulus packages to ward off the risk of another recession. Expansive monetary policy (through new programmes of quantitative easing) can also help keep the risk of recession at bay, although its effectiveness will be limited. Over the mid-term, only fiscal consolidation and structural reforms will be able to return industrialised countries to a path of sustainable growth.

For Spain the situation is particularly worrying because, unlike the US, Germany or France, it had not yet achieved significant levels of growth, has no scope for fiscal expansion and its jobless rate is the highest of any advanced country. The slowing of the world economy might mean a drop in Spain's growth and make it impossible to rely on exports as the driver of its recovery.

At the international level, a slowing of the world economy could prompt uncoordinated unilateral responses that would increase international tensions. A third wave of quantitative easing in the US would resurrect currency exchange rate tensions with emerging countries, and the persistence of high unemployment might unleash protectionist pressure and social unrest. All of this would cause governments to pay even less attention to international economic cooperation and to the increasingly necessary building of a new global economic governance.

Federico Steinberg
Senior Analyst for International Economy and Trade at the Elcano Royal Institute and Lecturer at Madrid's Universidad Autónoma