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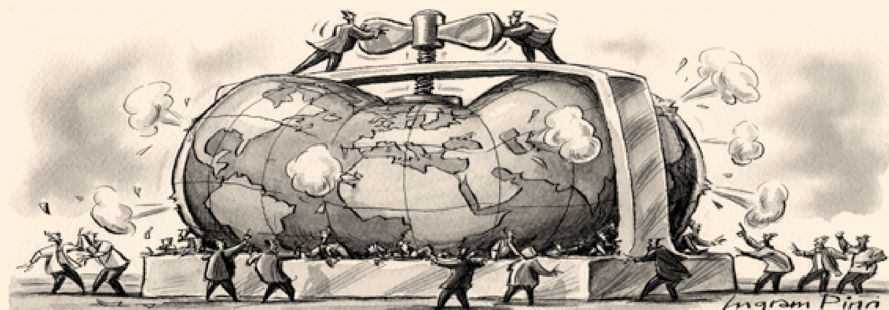
Why austerity alone risks a disaster

By Martin Wolf



Enjoy the coming slump. That is not what the Bank for International Settlements says to the US and other overindebted economies. But it is what its latest annual report implies. I admired the warnings of monetary and financial excesses that the BIS gave under its former economic adviser, William White. I respect Stephen Cecchetti, his successor. But I disagree with the thrust of this report. It understates the obstacles to across-the-board austerity.

Persisting with monetary and fiscal accommodation is uncomfortable. But unconventional times demand unconventional policies. What makes these times unconventional? The answer is that a number of economies are in what the Jerome Levy Forecasting Center calls a "contained depression" – a period of sustained private sector deleveraging.

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Implicitly, the BIS report rejects such a view. It argues for monetary and fiscal tightening across the globe. This argument rests on two beliefs. First, the world economy is close to full capacity. Second, "addressing overindebtedness, private as well as public, is the key to building a solid foundation for high, balanced real growth and a stable financial system. This means both driving up private savings and taking substantial action now to reduce deficits in the countries that were at the core of the crisis."

Consider, first, monetary policy. Suppose we had an inflation-targeting central bank for the world. How should it respond to rising commodity prices when inflation expectations are also under control? Such a bank would recognise

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that this is a shift in relative prices, which reduces capacity and real wages. It would not know whether the rises are a one-off or a lasting trend. It would want to avoid a jump in inflationary expectation or a wage-price spiral. But would it also wish to reduce nominal wage rises, to offset the inflationary impact of the rise in commodity prices, even if that risked a significant slowdown? I think not. If it did, it would impart instability into the real economy in response to erratic and unpredictable movements in prices of commodities.

In practice, not only do we have no global central bank but inflation conditions are divergent. In high-income countries inflation is reasonably under control. In many emerging countries it is shooting upwards, partly because the latter consume commodities more intensely and partly because their economies have expanded more strongly.

The right monetary policy would also be diverse. This, happily, is just what our world allows: emerging countries should tighten; and high-income countries should tighten more slowly. This is happening but not enough, because many emerging countries are desperate to avoid exchange rate appreciation.

What should high-income countries do? On this the BIS report does a signal service: it demonstrates that hysteria about the impact of larger central bank balance sheets is unjustified. But it argues that economic slack has disappeared. That this is true of emerging countries seems plausible. The BIS also points to the mistake made in the 1970s, when the impact of the oil price shock on capacity was underestimated. It argues that today, too, the amount of spare capacity is exaggerated. Yet unit labour costs and expectations are far better under control than then. Now, I would argue, is when central banks use up their credibility. They must watch inflation expectations. But they do not have to act pre-emptively.

Now turn to the yet more debated question of fiscal policy. The question I have is this: does the BIS know that every sector cannot run financial surpluses at the same time?

Few doubt there is excessive private sector debt in a number of high-income countries. But how is it to be reduced? The BIS notes four answers: repayment; default; higher real incomes; and inflation. Let us rule out the last and focus on the first. Repayment means spending less than one’s income. That is what is happening in the US private sector (see chart). Households ran a financial deficit (an excess of spending over income) of 3.5 per cent of gross domestic product in the third quarter of 2005. This had shifted to a surplus of 3.3 per cent in the first quarter of 2011. The business sector is also running a

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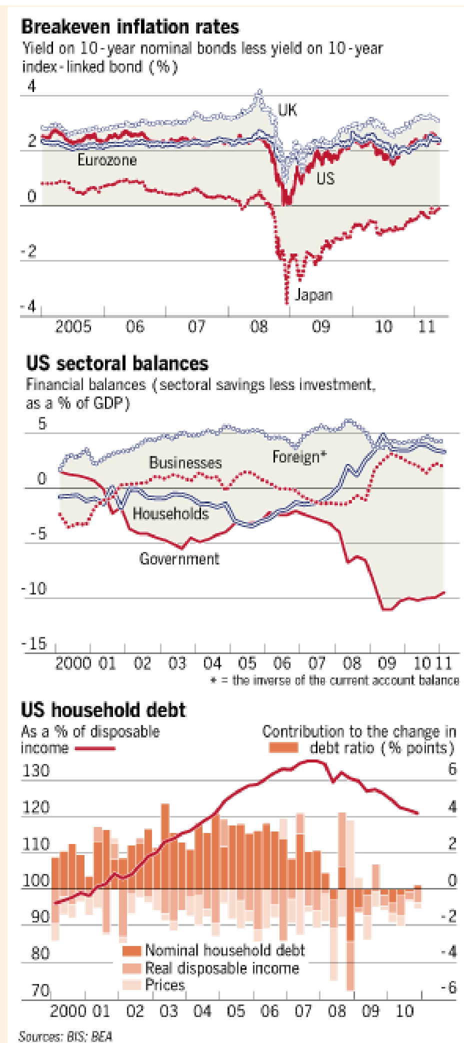

modest surplus. Since the US has a current account deficit, the rest of the world is also, by definition, spending less than its income. Who is taking the opposite side? The answer is: the government. This is what a controlled depression means: every sector, other than the government, is seeking to strengthen its balance sheet at the same time.

The BIS insists this is not good enough: highly leveraged countries are running structural fiscal deficits, which must be eliminated as soon as possible. Fair enough, but where are the offsetting adjustments to occur?

The evidence suggests that the foreign surpluses are structural or at least highly persistent. Given these debt overhangs, surpluses of household sectors are also likely to be sustained. So a big reduction in these fiscal deficits probably demands an offsetting reduction in business sector financial surpluses. That can happen in two ways: a surge in business investment or a reduction in retained earnings. The former would be adjustment via growth and the latter adjustment via a slump. Which is more likely? If you believe a sharp monetary and fiscal tightening would result in an investment boom, I have a bridge to sell you. If the more plausible adjustment is via shrinking profits, that surely implies a fall in output. If so, this would preclude lowering the debt overhang via higher real incomes. That then leaves default. This would work, but via a slump and destruction of financial assets.

This process of thinking through offsets to a sharp fiscal tightening is inescapable. The answer that avoids yet more problems in the private sectors of overindebted countries is a shift in external balances. Thus, the external rebalancing – more or less blocked, at present – and fiscal rebalancing are two sides of a coin.

The BIS is right: normalisation of monetary and fiscal policy is needed. But it is impossible to eliminate structural fiscal deficits until either the private sector structural adjustment is complete or we see big shifts in the external balances. It is impossible, finally, for this external adjustment to occur without big changes in the surplus economies.

The BIS boldly calls for simultaneous private and public deleveraging. But what are to be the offsets? That is the question. The BIS provides no convincing answer.

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revolutiononline | June 29 12:54am | Permalink Report

Last night I remarked on the Gavyn Davies Blog about the deafening silence from the FT about that Stephen Cecchetti BIS Report - my comments can be read there. I am limited in the "interventions" I can make because the FT have banned ("gagged", in actual fact) Joseph Belbruno until the end of August (!). So I will have to ask fellow participants to follow us there for further comments. We will also have our ongoing online commentary on FT and stories from major world media sources on a new website that will start in days at www.eforum21.com .

Martin Wolf's analysis is impeccable (after all, if you are intelligent and fair and you are very knowledgeable on a subject, why should your analysis be mistaken?), so I will turn briefly to the obstacles in its way. Over a number of months now, Joseph Belbruno has been pursuing both this line of analysis but based on a different theoretical framework here in Martin Wolf Columns or at the Gavyn Davies Blog or at the Economists' Forum - so you can follow him there or you can check his archive in a few days at the site linked above.

The question is: if what Wolf suggests is right, then why is it not "implemented"? What are the "obstacles" and "who" is posing them? In a nutshell, the obstacles are set by the fact that the world economy through the Great Moderation was operating on the basis that what was produced cheaply in China and other "emerging economies" (BRICs, for instance) could then be "exported" in large part to the United States where real and nominal wages couls remain low (no inflation) and the capital accumulated could be re-invested through the Western financial institutions ("core" centres like New York and London). The upshot was that much of this capital could simply no longer be invested "profitably" by producing real goods for consumption - because this would entail a rise in living standards of workers, which in turn would "emancipate" them politically and cause (you guessed it) inflation and political upheaval.

Not used to such largesse, Finanzkapital had to invest the capital earned on the blood and sweat of poor workers in China and other places by beginning a phenomenal wave of "speculation" on "real assets", from mortgages to commodities, because when there is such a "surplus" of capital it is better to "go for safety" and buy "real assets" instead that are essential to the reproduction of capitalist society. And this is precisely what happened, initiating a speculative wave that gathered tsunami strength until inevitablt it hit the shores of Western capitalist financial institutions - resulting in the Great Financial Crisis.

Once you understand this new "framework of analysis", the rest pretty much follows. But rather than bore you here, I will ask you to follow me at the Gavyn Davies Blog and, again in a few days, at the website linked above. Cheers to all.

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graeme_b | June 28 10:47pm | Permalink Report

I'm afraid you're trying to bash a square peg into a round hole here - you must've started with the orthodox Keynesian conclusion and worked backwards from there...

Two things I disagree with:-

1) "In high-income countries inflation is reasonably under control."
No, it is not. Price inflation of the essentials of life is not under control: food, water, fuel etc. (and taxes! essential if you want to avoid jail). We probably *are* near full capacity for these things. Recall a recent quote in the news: "I can't eat an iPad" - I submit to you that perhaps you are somewhat detached from the every day reality confronting the great unwashed. You are probably thinking that broad money is not expanding at this point. The truth is that inflation has already happened - what we face now is a choice between allowing it to spread from assets to commodities, versus allowing asset prices to collapse and burn the creditors (I am fully aware which choice the powers that be prefer).

2) "Few doubt there is excessive private sector debt in a number of high-income countries. But how is it to be reduced? The BIS notes four answers: repayment; default; higher real incomes; and inflation. Let us rule out the last and focus on the first."
Since we have 4 solutions, why do you insist we focus on the first? Could it be because this line of thought leads to the desired conclusion? Socrates would be proud. In fact the West would be well-advised to pursue *all* of these solutions, which is why a certain amount of recession would be desirable to shake out the worst loans (*default*), and redistribute the most seriously misallocated capital. Sustainable *higher real incomes* are most likely to come about in the long run by shrinking the state and cutting taxes - i.e. the supply side - government spending has an unfortunate tendency to be wasteful and unproductive (unless you consider votes to be value for money). Finally, *inflation* seems inevitable - look on the bright side - in real terms, wages in the West will fall to a more realistic level, which should be good for employment.

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