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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.

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."

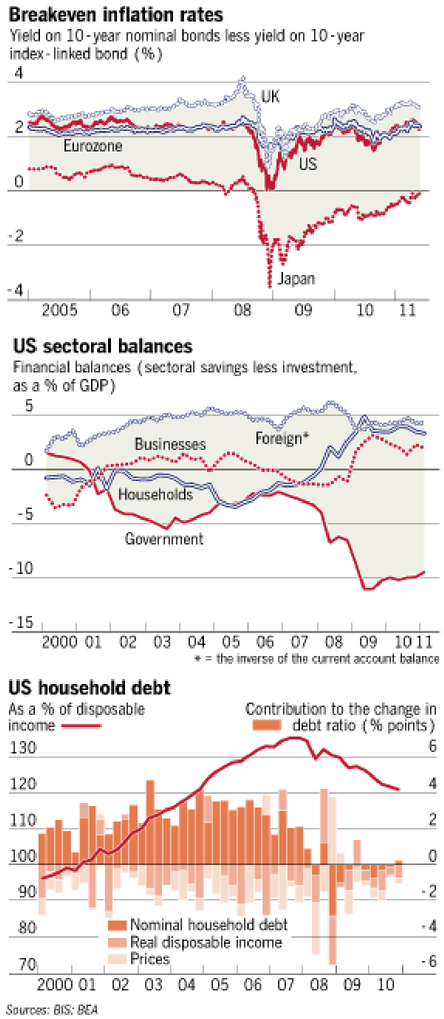
Consider, first, monetary policy. Suppose we had an inflation-targeting central bank for the world. How should it respond to rising commodity prices when inflation expectations are also under control? Such a bank would recognise that this is a shift in relative prices, which reduces capacity and real 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 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.