High Public Debt, Stagnation, Deflation and Unemployment: Policy Errors and a Way Forward

Author: Richard Wood · August 19th, 2014 · Comments (0)

This note reviews monetary and fiscal policies adopted by Japan, the United States and Eurozone periphery countries during the global financial crisis and subsequently. These countries all experienced similar economic problems: high public debt burdens, the deflation tendency, credit traps, inadequate aggregate demand and high unemployment.

It is argued below that policymakers anchored their strategic thinking in policy paradigms—bond financing of budget deficits, fiscal and wage austerity, asset purchases by central banks, reliance on bank lending channels and market solutions, ultra-low longer term interest rates—that were, or became, no longer appropriate or adequate to deal with this new set of medium-term macroeconomic problems. As a consequence, it is arguable that substantial errors have been made in the application of macroeconomic policies.

Policy Successes and Policy Failures

The initial large-scale multilateral fiscal stimulus, the lowering of the policy (short-term) interest rates and the regulatory responses to the banking crisis were unquestionably appropriate initial general policy responses to the collapse of financial markets.

Identification and evaluation of policy errors are, of course, highly controversial exercises, particularly when accepted orthodoxy is questioned. We will focus on three likely major policy mistakes.

Financing the Fiscal Stimulus

We begin by questioning the method used to finance post-crisis budget deficits.

Ever since the gross excesses in the use of the printing press and new money financing of debt during the Weimar German hyperinflation, bond financing has become the preferred and recommended method of deficit financing. So when the global financial crisis hit it was natural, perhaps, for policymakers—many schooled predominantly in rational expectations, open market efficiency, conventional fiscal policies and the latest general equilibrium models—to not even consider whether orthodox bond financing of budget deficits would continue to be appropriate.

Had policymakers had sufficient understanding of what was about to happen to public debt burdens they may well have adopted a different policy approach to deficit financing. This then raises the possibility that a large policy mistake was made when it was ‘subconsciously’ accepted by policymakers around the globe that the large fiscal stimulus needed to address collapsing demand would be funded by issuing new government bonds. The issuance of those government securities added directly and substantially to the size of the public debt.

Monetary Policy
The development of monetary policy, particularly from late 2010 onwards, is highly controversial.

Quantitative easing (asset and bond purchases by the central bank) directly increases ‘asset’ and ‘bond’ prices only. With asset and bond purchases, the ‘money base’ in directly increased but the ‘money supply’ may not be significantly impacted. The injection of massive volumes of new money into the financial sector via quantitative easing is not highly stimulatory of investment in plant and equipment, consumption or output, as many had claimed. There may as well, therefore, be few, if any, significant direct channels of causality by which quantitative easing could raise ‘consumer price’ inflation.

As the debt-and-derivative-fuelled asset bubble burst a credit crunch occurred, and, as interest rates fell to zero bound, we then witnessed the development of credit traps where credit was constrained not by high borrowing costs but increasingly by demand (deleveraging, reduced household wealth, higher private savings, a sustained fall in the investment to GDP ratio, etc.) and supply (balance sheet repair, higher liquidity and capital ratios, etc.) forces. In such circumstances it is questionable whether central banks needed to go on pouring excessive volumes of new money down into credit traps in order to attempt to further lower longer-term interest rates. In the process, of course, they added to un-loanable savings and increased surplus, unusable and un-loanable reserves of commercial banks, distorted central bank balance sheets, and created asset price bubbles. Yet monetary policy remained directed at lowering the cost of borrowing, even though the lower bound on the policy rate had already been reached.

In an environment where private and public debts are excessive, and policy interest rates are at zero bound, new money creation should be used to avoid the unhealthy building-up of new additional debt burdens, to by-pass credit traps, and to provide purchasing power directly to households rather than to lending institutions.

Arguably, risk-taking has been distorted, and asset prices have already moved far beyond what the real economic fundamentals would suggest is reasonable. When interest rates are finally increased, to ‘prick’ a bubble, the fallout could be widespread and of unpredictable magnitude, and the inappropriate risk, resource and investment allocation decisions, encouraged by sustained ultra-low interest rates, will then, in time, become increasingly apparent, and adversely affect the real economy.

The continued application of quantitative easing beyond 2010 in the United States, but also in Japan, has arguably represented an additional policy miscalculation.

Fiscal Austerity

Blanchard and Leigh, ‘Growth Forecast Errors and Fiscal Multipliers’, IMF Working Paper, WP/13/2013, and De Grauwe and Ji, ‘Panic-Driven Austerity in the Eurozone and Its Consequences’, VoxEU, 21 February 2013, have reasonably demonstrated that fiscal austerity policies have been counter-productive. These policies cutting government expenditure or raising taxes contribute to deeper recessions and higher public debt. This result has been more recently confirmed by Riera-Crichton, Vegh and Valentin, ‘Fiscal multipliers in recessions and expansions: Does it matter whether government spending in increasing or decreasing?’ Preliminary Draft, March 31, 2014.

An Alternative Set of Monetary and Fiscal Policies

From a fiscal policy perspective, when monetary interest rates are at or near zero bound, and the real rate of interest consistent with full employment is negative, countries suffering from inadequate aggregate demand require strong fiscal stimulus. But where such countries have high public debt levels there is no further room for conventional bond financed fiscal stimulus, particularly where countries do not have their own currencies. So, it is concluded, fiscal policy options are exhausted.
From a monetary policy perspective, where interest rates are at, or close to, zero bounds; where real rates of interest consistent with full employment are negative; and where credit traps are widespread and constraining lending and economic expansion, one might conclude, in line with modern textbook accounts of monetary policy, that all monetary policy options have also been exhausted, or virtually so.

The implication usually drawn from the above two paragraphs is that both monetary and fiscal policies have reached their limits, and that we are all condemned to secular stagnation. Fortunately, this is definitely not the case.

However, a different paradigm involving greater monetary and fiscal policy coordination is required to reinvigorate aggregate demand in countries suffering high public debt, credit traps, the deflation tendency and high unemployment. The new plan involves the creation of new money.

By channelling new money to the household sector, rather than into the financial sector and down credit traps, there is a much greater probability that consumption – the main component of aggregate demand – will increase. The credit trap will be bypassed: fruitless new money injections into banking sectors already bloated by previous new money injections, and with constrained lending opportunities, will be stopped. Beyond some point, the rise in consumption expenditures, induced by the fiscal stimulus, will call forth price increases for consumer goods and services: investment, employment and wages will tend to increase in turn. In this way the tendency toward deflation and stagnation will be addressed, and unemployment reduced.

This new combination of fiscal and monetary policies – fiscal stimulus and the new money financing of it – is called Overt Money Financing.

Overt Money Financing:

1. represents the most powerful monetary and fiscal policy combination, and requires strong coordination between fiscal and monetary authorities;

2. does not increase either interest rates, government borrowing requirements or public debt, does not withdraw funds from the economy (as does bond financing), does not involve crowding-out and nor are there any Ricardian Equivalence effects to be concerned about. Overt money financing is, therefore, especially suitable to situations where public debt is already excessive, interest rates are at zero bound and when liquidity or credit traps are present;

3. can be applied if there is or is not an independent central bank, and it could be implemented by the Treasury/Ministry of Finance acting alone;

4. can be applied if Eurozone countries remain inside the Zone or leave it. Is not precluded by Article 123 of the Lisbon Treaty as the use of new money created by the European Central Bank can be transferred to individual governments in the Eurozone using non-debt financial instruments;

5. does not promote risk-taking or create asset price bubbles;

6. does not create a consumer price inflation threat because if and when inflation did begin to rise above target levels excess liquidity can be removed. In the near-term, however, the new money will be needed to finance the higher rate of economic expansion.

7. does not pour money down into the credit trap, but does successfully inject new money and purchasing power to households with a relatively high marginal propensity to consume, and into the real economy.

8. is not, as is often claimed, equivalent to bond financing and quantitative easing (see Wood R, ‘Helicopter Money Debate:...

A longer and complete paper can be found at: Wood R, ‘Europe, the United States and Japan: Recent Macroeconomic Policy Errors and a Way Forward’, School of Economics Discussion Paper, No. 530, August 2014, School of Economics, University of Queensland, Australia.

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