The crisis left a grim legacy, and the answers are likely to be unorthodox

The principal high-income economies – the US, the eurozone, Japan and the UK – have been suffering from “chronic demand deficiency syndrome”. More precisely, their private sectors have failed to spend enough to bring output close to its potential without the inducements of ultra-aggressive monetary policies, large fiscal deficits, or both. Demand deficiency syndrome has afflicted Japan since the early 1990s and the other economies since 2008 at the latest. What is to be done about it? To answer, you have to understand the ailment.

Crises are cardiac arrests of the financial system. They have potentially devastating effects on the economy. The role of the economic doctor is to keep the patient alive: preventing the financial system from collapse and sustaining demand. The time to worry about a patient’s lifestyle is not during a heart attack. The need is to keep them alive.

Like heart attacks, financial crises have long-lasting effects. One reason is the damage to the financial sector itself. Another is a loss of confidence in the future. Yet another is that it makes the debt accumulated in the run-up to the crisis no longer bearable. What happens then is a “balance-sheet recession” – a period when the indebted focus on paying down debt. Post-crisis policy has to offset or facilitate such private-sector deleveraging. Supportive monetary and fiscal policies can help do both. Without such policies enormous slumps are likely, as happened in crisis-hit eurozone-member countries.

A complement to deleveraging is debt restructuring. Many economists have recommended such restructuring as an essential part of the solution. In the household sector at least, the US has done a far better job of this than the eurozone. But organising debt restructuring is extremely difficult so long as borrowers refuse to admit defeat. This is true of the private sector and even more so of the public sector. This is one reason why debt overhangs last so long.

Yet there are even more disturbing possibilities than debt overhangs. In my book, The Shifts and the Shocks, I suggest that a number of shifts in the world economy created chronically weak demand in the absence of credit booms. Among these were excess savings in emerging economies and shifts in income distribution, ageing and a secular decline in the propensity to invest in high-income countries. Behind these shifts lay, among other things, globalisation, technological innovation and the growing role of the financial sector. It is not
enough to clean up after the debt boom has collapsed. Policy makers also have to eliminate the dependence of demand on unsustainable credit.

Without that, even a radical clean-up will not deliver buoyant demand. True, if a country is small, it may be able to import the missing demand via the external account. But when huge parts of the world economy are afflicted, alternative solutions are needed. There are three broad alternatives: live with chronic demand weakness; run aggressive demand policies indefinitely (as Japan has done); or fix underlying structural demand weaknesses.

Hyper-aggressive monetary policy helps by delivering real interest rates that are well below zero. An alternative is fiscal deficits. But that risks putting debt on a permanently rising path. Still more unorthodox is outright monetary financing of fiscal deficits, as Adair Turner, former chairman of the UK’s Financial Services Authority, has recommended. This means nationalising the creation of money now delegated to often-irresponsible private banks. This is a more direct (and probably more effective) way of using a central bank’s power to create money in order to expand demand than employing it indirectly, via manipulation of asset prices. Such direct monetisation of deficits seems particularly sensible in Japan.

The alternative is to address the sources of structurally weak demand. One policy would be to redistribute incomes from savers to spenders. Another would be to promote spending. This is why Japan’s consumption tax increase was so misconceived. Japan should tax savings instead. This violates the prejudice that thrift is valuable. But in a world suffering from demand deficiency syndrome, it is not. Unproductive savings should be discouraged.

Beyond both the post-crisis malaise and persistently weak demand lies the possibility of structurally weak supply. The solution is encouragement to work, invest and innovate. But policies designed to promote supply must not simultaneously weaken demand. This is one of the difficulties with the boilerplate recommendation of labour market reform, which entails lowering wages for a large proportion of the labour force and making it easier for employers to hire and fire. This is likely to lower consumption at least in the medium term – precisely Germany’s experience in the first decade of the 2000s. Reforms should promote demand. That is why the eurozone must settle on a balanced package, not excessive reliance on structural reforms.

The crisis left a grim legacy. The eurozone has done a worse job of dealing with this than, say, the US. But the origins of the crisis are to be found in longer-term structural weaknesses. Policy has to address these failings, too, if exit from the crisis is not to be the beginning of a journey into the next one. The answers are likely to be unorthodox. But so, too, is today’s economic condition. Rare ailments need unusual treatments. So look for them.

martin.wolf@ft.com

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