We still have that sinking feeling

By Martin Wolf

It is nearly five years since financial turmoil broke upon an unsuspecting world, in August 2007. So how are crisis-stricken high income countries doing? Badly, is the only answer.

Of the six largest high income economies (plus the eurozone), only those of the US and Germany are above previous peaks. Since the US was the epicentre of the early shocks, its recovery has been relatively good. Yet none of these countries can be happy with its performance. While US gross domestic product has been more buoyant than that of these other countries, its unemployment rate more than doubled, from 4.7 per cent in July 2007 to 10 per cent in October 2009. Since then its unemployment has fallen only a little. But the US has still had a better performance than the eurozone, whose economy is stagnant and whose latest rate of unemployment is 11.1 per cent, against 8.2 per cent in the US.

Economies stagnate, while policy is aggressive. The highest short-term interest rate offered by any of the central banks of the big high-income economies is the 0.75 per cent offered by the European Central Bank. Balance sheets of central banks have also doubled in the big high-income countries, relative to GDP, since 2007. Japan, the US and UK continue to run very large fiscal deficits for peacetime. Yet despite huge fiscal deficits, long-term interest rates on Japanese, US and UK government bonds are very low, at 0.8, 1.5 and 1.6 per cent, respectively.

David Levy, of the Jerome Levy Forecasting Center, labels this conjuncture of sluggish economies with huge policy stimuli a "contained depression". The explanation is clear: a number of important economies are struggling with excessive leverage, particularly in their household and financial sectors. In the US, for example, total private sector debt rose from 112 per cent of GDP in 1976 to a peak of 296 per cent in 2008 (see chart). This ratio had fallen back to 250 per cent by the end of the first quarter of 2012, which is where it was in 2003. In 2007, US gross private borrowing was 29 per cent of GDP. In 2009, 2010 and 2011, however, it was negative.

Above all, private sectors are running large surpluses of income over spending. In the US, the financial balance of the private sector turned from a deficit of 2.4 per cent of GDP in the third quarter of 2007 to a surplus of 8.2 per cent in the second quarter of 2009. This massive shift would surely have caused a huge depression if the government had been unwilling to run offsetting fiscal deficits. That is how the depression was contained.

The US is the most important of the crisis-hit economies. But it is not the only one to have experienced large private sector retrenchment: so has the UK. In fact, the International Monetary Fund forecasts that the private sectors of all the large high-income countries will be in either balance or surplus this year (see chart). It follows that these countries must be running large current account surpluses or large fiscal deficits. Germany is doing the former. Others are running fiscal deficits. Since these big countries are unlikely to be able to run large current account surpluses together (with whom?), they have to run fiscal deficits once their private sectors run huge surpluses. These surpluses, in turn, are partly explained by the desire to de-leverage, partly by unwillingness to borrow and partly by the inability or unwillingness of the financial sector to lend. All this, then, is the painful hangover after the great credit binge.

So the big story continues to be one of private sector de-leveraging, tempered by easy monetary policy and offset by the leveraging of the government's balance sheet. The willingness of the authorities to do both of these things, despite foolish criticism, prevented us from experiencing a second great depression and continues to do so. The idea seems fantastic that these large fiscal deficits are crowding out private spending when interest rates are so low in countries blessed by not being in the eurozone.

Yet some official observers are distressed by these policies. In its latest annual report, the Bank for International Settlements apparently argues for monetary and fiscal tightening in high income countries. Yet it presents no comprehensible analysis of the consequences. It remarks, for example, that "fiscal multipliers in a balance sheet recession may be lower than in normal recessions. In particular, in a balance sheet recession, overly indebted agents – these days, households typically – are likely to allocate a higher fraction of each additional unit of income to reducing their debt rather than increasing discretionary spending". That is indeed possible. The conclusion is that fiscal deficits, readily financed in important countries, need to be still bigger because they must both facilitate de-leveraging and sustain demand. The other plausible way to accelerate de-leveraging is mass bankruptcy, also known as a depression. Does the BIS want that?

We know that big financial crises cast long shadows, particularly in countries whose underlying rate of growth is modest, which makes de-leveraging slow. Policy must both sustain demand and facilitate de-leveraging. This means aggressive monetary and fiscal policies, working in combination, along with interventions aimed at recapitalising banks and accelerating restructuring of private debt. The Obama administration attempted all this. But it was not ambitious enough. It was also thwarted by Republican intransigence. Yet, provided the US avoids going over its "fiscal cliff" later this year, a moderate private sector-led recovery should proceed. Once that is securely in place, serious fiscal consolidation could begin. Austerity should follow a strong recovery, not precede it

Unfortunately, the troubled big economies do not consist of the US alone. The crisis has also caused a deep rift inside the eurozone, the world's second largest economy. The latter's inability to craft a response guarantees turmoil. The people shaping policy worry more about moral hazard than about panic. This makes a wave of sovereign and banking crises, culminating in exchange controls and disintegration of the eurozone, all too conceivable.

Far too much policy making and advice neither recognises the post-crisis challenges nor crafts effective answers. The heart of the matter is accelerating de-leveraging, while promoting recovery. By that standard, the policies now in place are, alas, very far from good enough.

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