PERSPECTIVE

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PAYING THE PIPER

Financial market volatility looks likely to remain the dominant theme in the coming months, and the risks of a renewed recession in the advanced world have intensified. Europe's fiscal crisis is already an economic crisis, and it is threatening to go global. Bond markets are already fully pricing in a deep downturn. Meanwhile, equity markets seem less convinced, as the extreme fluctuations seem to reflect an ongoing tug of war between the pessimists and the hopeful. Time will tell which market is sending the right signal.

Fiscal risk dominates

All eyes are on Europe. Can the euro zone governments manage the insolvency and inevitable debt default of Greece without sparking contagion to other countries and a region-wide banking crisis? The recent G20 meetings drove home the need for Europe to act decisively. A strong policy response will come. Just like the last set of policies announced in mid-July, however, the issue is whether the 17 euro-member governments can all enact and then implement the commitments in a timely fashion. Execution is everything. It is also not clear that an expanded European Financial Stability Facility (EFSF) can achieve the desired outcome, as it has a structural deficiency. A larger EFSF corresponds to greater implicit fiscal liabilities for the core countries, which might call into question their financial capacity. Greece will most likely receive the next installment of its bailout, thus avoiding a default in October, but this simply kicks the can to mid-December when its fiscal progress will once again be assessed. The main message is that the European fiscal crisis will not be solved in the short term. Even fiscal integration and jointly issued European bonds could not remedy the fundamental problem at the root of the euro zone crisis: too much public and private debt and extremely poor economic growth potential.

Although Europe has dominated recent financial market attention, it is only a matter of time before the spotlight shifts once again to the U.S. fiscal and political risks. As part of the debt ceiling increase agreement, the Joint Select Committee was established. It was tasked with finding $1.5 trillion in fiscal consolidation over the next ten years. The committee must agree by November 23rd of this year or it will trigger automatic spending cuts that could jeopardize the economic recovery. The odds of compromise seem remarkably low in the current political environment. Make no mistake, America is solvent. The question is whether financial markets will understand this and appreciate that there is time and resources to address the fiscal imbalance. So far, the prevailing low level of bond yields show that fixed income markets are giving the U.S. a pass for the time being, but they will not wait indefinitely for a medium-term plan for debt stabilization.

All of this uncertainty is weighing on consumer and business confidence. Political leaders are complaining that businesses are hoarding cash, which could be better deployed to fuel economic growth. However, the decision is perfectly rational. Businesses traditionally assume that policymakers are there to save the macroeconomy if something deeply untoward happens. But monetary and fiscal policy are currently perceived as a spent force. Moreover, it is unclear at this stage how badly the willingness of consumers to spend has been impaired.

Understanding how we got here is essential

To many, the current environment is deeply confusing and frustrating. How could the advanced world be on the precipice of yet another downturn so soon after that of 2008/2009? The answer is that when the history books are written it will be made clear that the financial crisis never truly ended. It simply evolved in an environment of positive economic growth. Indeed, the failure of economic growth to accelerate to a pace that could bring about a material decline in unemployment revealed that the deleveraging process was far from complete in the United States and parts of Europe.

In order to understand what is happening, one needs a broad perspective of how we arrived here. Economies go through regular fluctuations – recessions, recoveries and expansions. During the expansion phase, imbalances are developed. At some point, there is a shock that causes a recession. The economic contraction purges the excesses, creates pent-up demand, and that demand is unlocked when the economic tide turns.

In the 1990s and early 2000s, the advanced world experienced a phenomenon that came to be known as the Great Moderation. It appeared that business cycles had become less pronounced. Recessions were happening less frequently. They were also less deep. Inflation became low and stable – as did interest rates. There was a sense that monetary policy had become more effective at limiting the pain of economic contractions.

Meanwhile, there was considerable liberalization of the global financial system that happened in conjunction with an information technology revolution, which facilitated dramatic innovation in financial products, such as complex financial derivative contracts.

The end result was a credit boom, particularly in the U.S. and Europe. Credit became too plentiful and too cheap. Households and financial institutions became too leveraged. As the funds chased returns, assets – particularly real estate – became incredibility overvalued in many countries. Households, businesses, financial intermediaries and investors became complacent about risk.

The Great Moderation ultimately meant that the magnitude of the underlying imbalances became enormous because the increase in credit and debt that carried the economy out of each period of economic weakness, and which suppressed macroeconomic volatility, was inherently unsustainable. It ultimately sowed the seeds of destruction.

It was inevitable that the piper would eventually have to be paid. The process of deleveraging started when the U.S. real estate bubble burst in 2007. It accelerated in 2008 with the financial crisis. However, the unwinding of the imbalances required an adjustment of dramatic proportions – roughly the size of a depression. As policymakers came to this realization in 2008, the implications were simply too unacceptable. This prompted an enormous and coordinated monetary and fiscal policy response.

The stimulus was successful in limiting the degree of contraction; and, by mid-2009, economic growth resumed. By constraining the degree and speed of household deleveraging, policymakers have prolonged the adjustment period. The inability of America to address the structural problem of millions of foreclosed homes reflects this. Spreading out the pain was justified from a social perspective, as high double-digit unemployment was avoided. However, slower adjustment implies slower economic recovery. And, in many respects, the inadequate saving problem by households was transformed into an inadequate savings problem for governments.

The needed deleveraging has impaired the effectiveness of monetary policy. It means that much of the advanced world is caught in a liquidity trap. Low interest rates and other incentives to borrow simply will not fuel significantly stronger demand in the United States and Europe until debts are reduced to a manageable level.

America's and Europe's lost decade

So, where is the advanced world headed? The best scenario is continued slow and fragile economic growth. In Europe, containment of contagion from Greece to other countries and recapitalization of the banking system are paramount. In America, policymakers must make progress in accelerating the deleveraging in the private sector, particularly dealing with the foreclosure problem. Only then can private sector demand be restored. Some additional short-term fiscal stimulus would be acceptable, but it should be focused at dealing with the prevailing structural problems and it would need to be accompanied by a medium-term plan of fiscal rebalancing. Immediate and significant fiscal restraint runs enormous risks. The fiscal rebalancing should occur over the coming decade, not the next couple of years. Ultimately, this economic and fiscal backdrop implies protracted slow economic growth, remarkably low interest rates and repeated efforts by policymakers to boost inflation in an environment of high unemployment. In other words, it will have many qualities of Japan's lost decade.

However, one also needs to be pragmatic. The scenario outlined above may be asking too much. The needed policy actions are truly exceptional and today's leaders didn't live through the painful economic times of the 1920s through 1940s. They have not experienced an economic depression and, thus, do not fully appreciate all that it entails. Moreover, governments are accountable to their citizens, and a significant portion of the population cannot fully grasp the magnitude of today's challenges. And, they have not been given any guidance on what to expect. Therefore, it is proving very difficult for policymakers to gather support for painful but necessary policy actions. Furthermore, today's investors are looking for the magic wand that makes the problems go away. No such wand exists. It is unreasonable for markets to simultaneously push for fiscal austerity and improved economic growth prospects. It is also unrealistic to expect that further monetary stimulus will materially change the outlook. The inability of leaders, citizens and investors to fully grasp all of the implications of the current environment may mean that the advanced world could be headed back into the valley for a period of time. In other words, further financial crisis and economic weakness in the U.S. and Europe might be needed to create progress.

The main message is that the imbalances created in the 1990s and 2000s will be eventually unwound. But, it will take considerable time. A lot of effort and unprecedented policies are needed to get us there. Moreover, even if economic growth is maintained, the feeling of recessionary times in the U.S. and Europe will persist until the private and public deleveraging is nearing completion some years down the road.

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