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Can Japan Come Back?

FRED BARNES ON POWERFUL GOP STAFFERS

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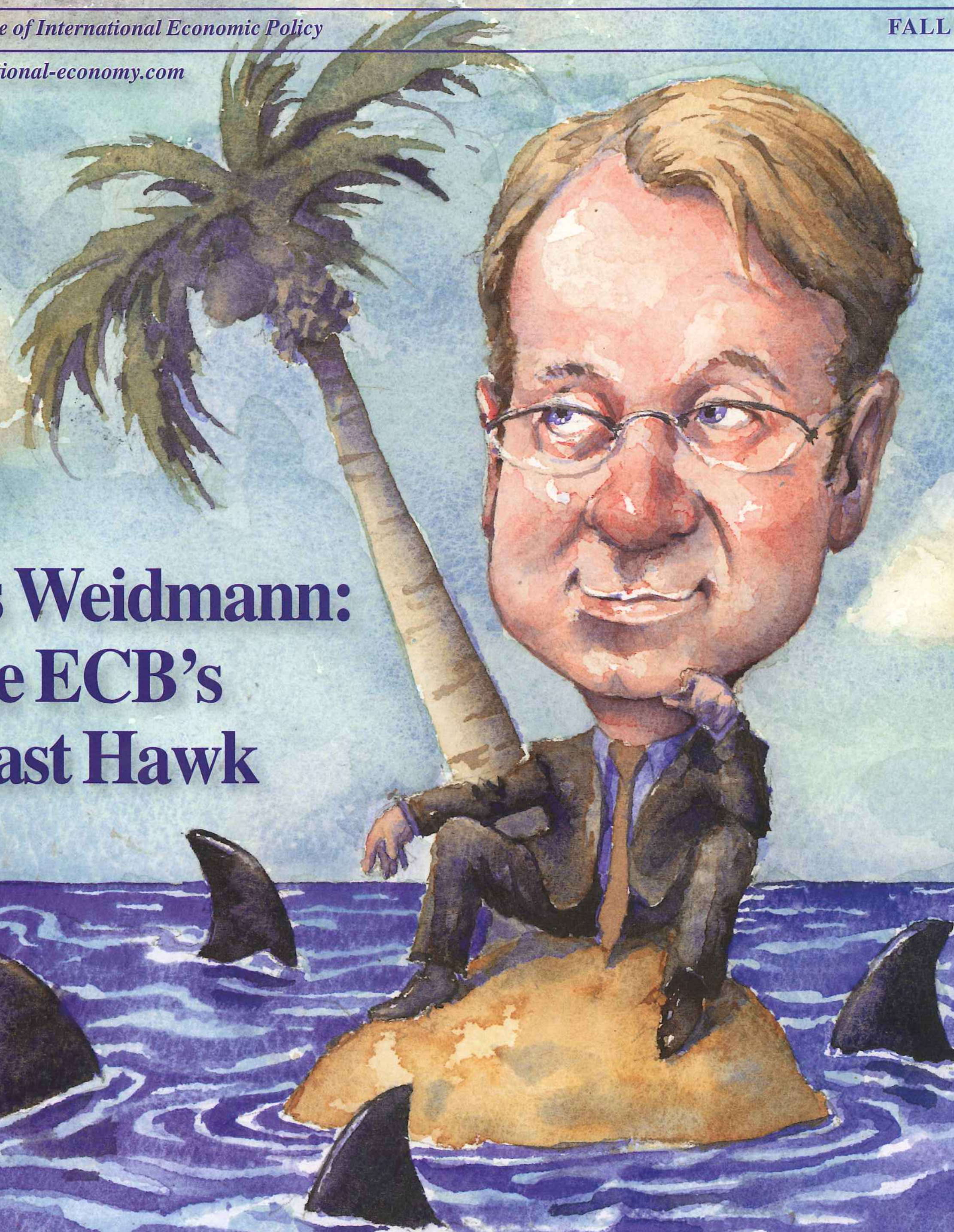
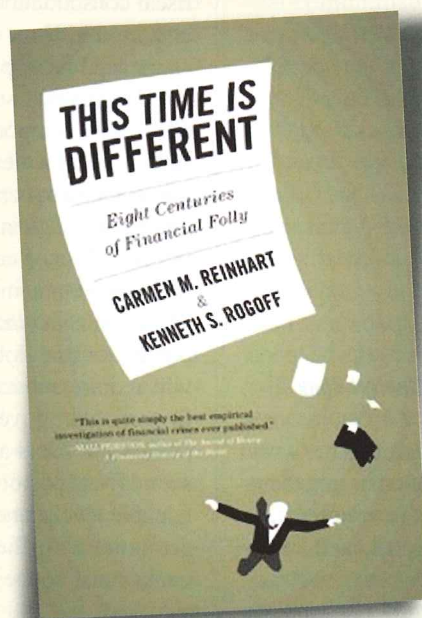


Jens Weidmann: The ECB's Last Hawk

Author's Note:

In the following symposium, Dr. Overholt's contribution is the fourth article.



The Rogoff-Reinhart Thesis

Some influential economic thinkers offer their perspectives.

In their 2009 book, *This Time Is Different: Eight Centuries of Financial Folly,* economists Ken Rogoff and Carmen Reinhart make the case that many analysts and policymakers utilized the wrong "framework" in addressing the financial crisis. The economists argue that the financial crisis was not a typical deep recession. Instead, it was a great credit contraction that "applies not only to output and employment, as in a normal recession, but to debt and credit, and the deleveraging that typically takes many years to complete," as Rogoff put it in a recent article. Because the global economy is massively over-leveraged, there is, therefore, no quick escape short of a transfer of wealth from creditors to debtors via either default or inflation. Short of either of those two developments, the world is in for a long hard slog of deleveraging that, as Rogoff and Reinhart put it, typically takes more than four years simply to reach the level of per capita income that existed during the pre-crisis period.

The Rogoff-Reinhart thesis argues that the U.S. fiscal stimulus has largely failed not because it wasn't big enough. Its framework was designed to fight a "great recession" instead of a "great contraction," in which the major problem is excessive debt. According to Rogoff, "If governments that retain strong credit ratings are to spend scarce resources effectively, the most effective approach is to catalyze debt workouts and reductions." This deleveraging process, however, takes time. That is why the world economy, in lieu of quickly responding to a bout of stimulus as many analysts had hoped and predicted, is likely to experience a slow, drawn-out recovery. Stated bluntly, the Rogoff-Reinhart thesis implies that in the initial stages of the financial crisis, well-meaning policymakers misdiagnosed the problem.

I only partially agree with the diagnosis.

JÜRGEN STARK
Member of the Executive Board, European Central Bank

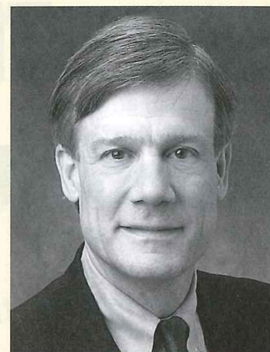
Ken Rogoff argues that policymakers around the world misjudged the character of the recent crisis and therefore applied the wrong policy tools to counter it. In sum, I only partially agree with his diagnosis and I fully disagree with his proposal for treatment.

Looking back, the crisis unfolded in three phases. First, it escalated in October 2008 with the default of Lehman Brothers, which triggered severe disruptions in financial markets and destabilized the banking system. At this stage, the policy response in Europe was twofold: national policies aimed to stabilize national banking systems via capital injections and guarantees, while the European Central Bank reduced policy rates and provided enhanced credit support to ensure an adequate liquidity supply.

In the second phase, while these measures helped to prevent a financial meltdown, a spillover into the real sector could not be prevented. As a consequence, economic growth contracted sharply by the end of 2008, which led policymakers in Europe to engage in a sizeable and coordinated fiscal stimulus. This second phase, the economic crisis, was followed by the third phase which we are currently experiencing, namely a government debt crisis affecting not only several European countries, but also large economies at the global level. It results from the fact that many countries entered the crisis with already-weak fiscal starting positions and therefore did not have adequate room for maneuver to avoid the occurrence of major fiscal imbalances.

Unlike Ken Rogoff, I would therefore argue that the economic policy response to the crisis—at least in Europe—has so far been a differentiated one. At the same time, I would fully support his view that an additional demand stimulus through discretionary fiscal policy measures would be counterproductive at the current stage. Such a strategy, through raising public debt burdens, would further raise fiscal sustainability risks, and thereby aggravate the adverse market reactions that are already severely undermining macroeconomic stability. I therefore agree that the deleveraging process in the aftermath of the crisis—although painful—is necessary and should not be delayed. Delaying fiscal consolidation would only increase adjustment costs and, in addition, undermine the credibility of already announced fiscal plans.

However, I strongly object to Rogoff's proposal to allow for a temporary but sustained deviation from price stability with a view to supposedly shortening the upcoming adjustment period. Such a strategy of devaluing existing debt through inflation would come at very high costs in terms of loss of central bank credibility and, as a result, macroeconomic instability if inflation expectations derail. The imbalances that have emerged both prior to and in the context of the global crisis need to be corrected and this will require substantial and sustained policy adjustment. In particular, governments will have to implement comprehensive fiscal and structural reform agendas to restore sound fiscal positions, bring down government debt to sustainable levels, and remove structural weaknesses in their economies. At the same time, the credibility of central banks must not be put at risk.



No, demand management is the proper response to the crisis.

JAMES E. GLASSMAN
Senior Economist and Managing Director, JPMorgan Chase & Co.

These days, leverage symbolizes all that is bad about today's economy. Of course, it's more than symbolic for the millions who purchased a house at the height of the speculative frenzy (between 2003 and 2007) and are now underwater—they owe more than their houses are worth on the market. In fact, pessimistic predictions assume that, because the leverage of American households is so high and must be lowered, debt burdens will shackle the U.S. recovery. Deleveraging can last for years, they say, so we should expect a slow drawn-out recovery rather than the usual burst of above-trend growth that quickly restores full employment.

Predictions that high leverage will strangle the economy have been around for decades, ever since household debt began to rise in the early 1980s. Yet they belie the spec-

tacular performance of the economy in this era of elevated leverage. Recall the productivity boom and secular rise in profit margins, which now stand at all-time highs, and the associated bull market in equities. Household net worth, although down from the 2007 peak levels which were exaggerated by inflated house values, has been historically high. At the same time, access to the open and robust U.S. economy enabled the eye-popping development of impoverished economies, a story that initially was feared for the "global imbalances" it spawned, but that actually proved to promote stability and rising living standards for half the world's people. Yes, the economy has been disrupted by recessions now and then, but these have occurred in periods of both low and high leverage. Could gloomy debt-centric predictions be exaggerating the case? Probably.

For one thing, pessimistic predictions assume that the damage from the recent financial crisis will take years to repair and this is almost certainly incorrect. The current crisis is little like those carefully studied by Carmen Reinhart and Kenneth Rogoff. Most past financial crises left the banking system severely undercapitalized. And most of those were caused by high inflation that forced the monetary authorities to maintain punishingly high interest rates. The current crisis is very different. Financial institutions have already "recognized" anticipated real estate losses. These are reflected in the loan loss reserves and the prices of mortgage-backed securities, thanks to the discipline of mark-to-market accounting. Most subprime loans were securitized, forcing lenders to revalue their books relatively promptly, and then some. At the same time, banks have raised hundreds of billions of dollars of fresh capital and now maintain even bigger capital buffers than at anytime in recent memory. For sure, borrowers and lenders will be working through the overhang of foreclosed and underwater properties for years to come, but the "recognition" of expected losses and strong capital position of American banks implies that the dangers to the economy are mostly in the past.

In contrast to the mistakes of the "subprime era," the earlier rise in household leverage by prime mortgage borrowers was a rational response to favorable economic trends. That leverage is not a threat to the economy. Why? As inflation and interest rates came down in the 1980s and 1990s, thanks to the Federal Reserve's inflation successes, borrowers refinanced high-rate mortgages or took on bigger debt obligations while maintaining or lowering their monthly debt service. For example, the debt service on a $250,000 mortgage today is identical to the typical debt service on a $100,000 mortgage in the early 1980s at prevailing interest rates. So, although households today have twice as much debt on average relative to income as was customary before the 1980s, debt service today is historically low at 11.5 percent of income—debt service has ranged from 10.6 percent of income in the early 1980s to 14 percent in 2007 (financial obligations, a broader measure of financial commitments, are 16.4 percent of income currently, towards the low end of the historical range that runs from 15.5 percent in the early 1980s to 18.9 percent in 2007).

Even if debt service is quite low, pessimists predict that households still must lower debt to build up their savings balances, especially as more and more prepare for retirement. That's unlikely. Saving is guided by savings—that is, household net worth. With net worth currently about where it was in the mid-1980s, and households saving 5 percent of their income as they did back then, U.S. saving is consistent with customary consumer behavior. No doubt many worry about adequate savings when they head into retirement, but with household net worth currently higher than it was for generations of Americans before the 1980s, there is little reason to assume that American households are about to become thriftier.

In contrast to assertions by Reinhart and Rogoff, traditional demand-management policy tools are precisely the proper "framework" for dealing with the current financial crises. Leverage that finances unprofitable investments creates balance sheet losses or wipes out net worth, regardless of who bears the burden—creditors of financial institutions or ultimate borrowers. Wealth losses depress consumption. Insufficient aggregate demand is today's principal challenge. And with bank balance sheets strong, there are few weaknesses in the system that require special policy initiatives.

This opinion is the author's own and not necessarily that of JPMorgan Chase.

I'm skeptical.

ROBERT JOHNSON

Executive Director, Institute for New Economic Thinking, and Former Managing Director, Soros Funds Management

Central to an understanding of the long and painful aftermath of the 2008 financial crisis is the existence of the debt overhang and over-leverage in the U.S. economy. This is the thesis of Reinhart and Rogoff and was also a focus in the earlier work of Irving Fisher in the 1930s

and the work of Richard Koo on the Japanese lost decade. The deleveraging process of debt and credit creates strong and persistent headwinds for economic recovery that are difficult to comprehend when using traditional macroeconomic models.

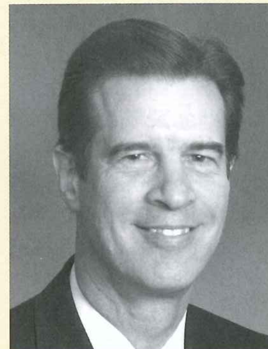
In this context, traditional estimates of fiscal policy's impact on activity and job creation may overestimate the "bang for the buck" of fiscal spending, be it tax cuts or expenditures in the short run. In a balance sheet recession, the proceeds of expansionary policies may be used to pay down debt or added to precautionary cash balances rather than used to expand spending on goods and services or hiring.

Many analysts misperceived the context of this crisis. Had they seen the importance of balance sheet overhangs, they would have recommended more vigorous policy initiatives than was customary in response to the business cycle. Had policymakers viewed the challenge from the vantage point of the Reinhart-Rogoff framework, they would have moved more aggressively to generate moderate inflation, to enact larger and longer-term fiscal stimulus based on spending rather than tax cuts, and been much more proactive in the removal of debt overhangs by restructuring debt.

Moderate inflation would diminish the value of outstanding debt and make it easier to pay off and service. Larger fiscal policy programs focused on spending rather than tax cuts would raise the propensity to spend per dollar of increase in the fiscal deficit and offset the drag on the fiscal multiplier induced by the debt overhang. Longer-duration fiscal programs are needed to support activity and create the time needed to work off the debt overhang. My preference would be to focus on programs that rebuild education, science research, and infrastructure, which would raise the productive base of the economy and attract new private investment, making it easier to service the debt created by the program in the long run. Such programs are not "shovel ready," but they do have longer lasting benefits.

Restructuring debt, particularly mortgage debt in this instance, would free up consumers to spend, release greater labor mobility that would bring down unemployment, and support private demand. But this is not a free lunch. Debt restructuring would also have some retarding effects. Creditors would experience a negative wealth effect, as they would be forced to realize a loss on an asset they had previously hoped would recover value. Finally, to the extent that financial intermediaries hold the debt that is being written down—as they do now, particularly second mortgages and home equity lines of credit—a recapitalization of financial sector balance sheets would be required to offset a credit contraction in that sector, otherwise this contraction could breathe deflationary winds across the entire economy.

Was failure to properly diagnose the problem the cause of policy inadequacies? I am skeptical. Even if we used the proper balance sheet perspective espoused by Reinhart and Rogoff, I'm not sure the proper policies would have been enacted. With the financial sector's strength in the money politics of Washington, it is not at all clear whether enlightened officials could have implemented large-scale debt restructuring policies to clear off the overhang. Politics is often a contest over who pays as much as it is a fight over what is proper policy. Furthermore, the disparity between views on the left and right on the role of the public sector looms large in relation to the question of fiscal spending. Vigorous and successful infrastructure programs might well shore up our stagnant economy but at the cost of enlarging the role of the government in the economy for a long time to come. There are some on the right who would rather see the economy suffer greater pain in the short to medium term and avoid the risk of a larger state presence in the longer term. The fight over the role of government in society is raging in our nation's capital, and it is not clear that anyone can do anything productive for the economy, however thoughtful, while that battle thunders on.



It may be politically impossible to do what's needed.

WILLIAM H. OVERHOLT

***Senior Research Fellow, Kennedy School, Harvard University, and author of* Asia, America and the Transformation of Geopolitics (Cambridge University Press, 2007)**

The crisis had three major impacts: high unemployment, a credit infarct, and persistent excess debt. Stimulus was necessary but not sufficient. Without stimulus, the worst impact of the crisis, unemployment, would have been far worse. Stimulus didn't fail. It wasn't really tried. The net stimulus was zero, since local government cuts offset the federal stimulus. Moreover, the U.S. system is inherently very slow to legislate and adjudicate shovel-ready projects. Patronage distribution and an emphasis on socially desirable projects tangential to unemployment, such as green energy and computerizing medical records, diluted the stimulus.

The failure to balance "stimulus" with a long-term fiscal consolidation plan, even though a bipartisan commis-

sion had recommended one, was a failure of political courage at a historic moment. Of course, doing so would have been extraordinarily difficult and politically risky, but that is what leaders of the executive and legislative branches are for.

The credit infarct made it essential to save the financial system, and the bailout was the most urgent and laudably successful task. It may make a profit. But it was not necessary to make bondholders completely whole, save shortsighted managements, and retain certain key institutions intact. The persistent excess private debt, notably in mortgages, made it necessary to negotiate reductions in debt through modification of principal or interest rates, at the cost of haircuts for the banks. Failure to make banks pay the price of mismanagement, for instance making bondholders whole and saving Citibank intact, while simultaneously failing to renegotiate the terms of underwater mortgages, had damaging consequences.

These detailed decisions about the way the credit infarct was resolved maximized moral hazard for the future. They prolonged and weakened the recovery and risked a second dip in the recession. And they so angered middle America that they fueled the Tea Party, worsened political gridlock, and thereby maximized the risk of double-dip recession.

The argument that no banks could be nationalized, that Citibank had to be kept intact because it would have been impossible to find competent managers to run or gradually dismantle it, was a rationalization by members of the financial club. The center of gravity of Wall Street revolted against one early plan precisely because it entailed rescuing Citibank. Forcing the banks to modify a wide range of loans early would obviously have been a tough sell in the face of the bank lobby, but it would have shortened and ameliorated the process of clearing the property market, enabled many unemployed to move to better prospects instead of being tied to unsalable homes, and ultimately saved the banks from much of a decade of debilitating mess. By reducing Main Street's sense of unfairness it would have lessened support for the Tea Party and created a chance of avoiding total political gridlock.

Of course, twenty-twenty hindsight is much easier than managing in the maelstrom, and it may have been politically impossible to do what was needed. But it would be comforting if someone had tried. ◆