Exit Strategy? Eastbound

Roberto Tamborini | Dec 17, 2009 12:23PM

History tells us that it is the exit strategy from a crisis that paves the way to the next one. The most recent instance has been the US exit strategy from the double shock of the dot.com bubble and the Twin Towers attack.

At present we already know where the fuel of the next big fire is: public debt in the more advanced countries. This is all the more obvious since the ongoing massive swap from (almost) worthless private debt to (almost) guaranteed public debt will be the lasting bequest of the current crisis. Latest forecasts say that the average debt/GDP ratio of OECD countries will soar from less than 70% to more than 100% in the next few years. For some of these countries this ratio is already climbing fast and will probably reach unprecedented heights, unless fiscal stabilization interventions are taken rapidly regardless of the state of the real economy.

For the time being, alarm bells ring more in Europe than elsewhere. In one year, spreads of almost all EU public bonds over the German Bund have nearly doubled (with German private and public finances themselves not being in a particularly sound health). Some of the governments in more acute troubles reside in non-marginal countries such as Greece, Ireland and Spain. A second circle might include Italy and possibly the UK in the not too far future. Let alone Eastern Europe. Early this year, speculators already set out for a hunting game against (supposedly) weak sovereign debts (see e.g. my post here) showing a mix of cynicism and masochism, since the so-called "financial community" has certainly not refused generous state aids, and everybody knows that the private-public debt swap is simply the natural by-product of governments taking care of the financial crisis. The EU institutions (including a reluctant ECB) sent then, and should send now, the message to markets that public *finance imbalances are going to be a systemic problem as they arise from a systemic market failure; hence they need a systemic approach*.

What does systemic approach mean? First, it means that in few years time public finance imbalances will be a global problem, including first and foremost the US. It will definitely not be a problem of the euro area alone, nor a collection of problems of single profligate governments to be harnessed, or punished, by piecemeal "market discipline". The latter is an important principle in ordinary times, and in some cases fiscal troubles are not only due to the crisis; but this crisis, like many others before, has shown that, in a context of fragile financial interconnections, punishing one to educate many may have disastrous consequences for all. Moreover, if it is in the public interest to rescue large and interconnected financial institutions from failure, the same argument applies to the governments who have to bail them out. And it also sounds somewhat paradoxical that "discipline" should be expected to come from the same "markets" whose indiscipline is at the very root of the problem (see also De Grauwe, *Financial Times*, January 22). To say the least, unless profound changes take place, "the markets" have proved to be dramatically unsuited to deal with the systemic consequences of their embedded trading strategies.

Second, since the orderly financing of large fiscal imbalances of the core OECD countries will be a major task (if not "the" task) of the world financial system for quite a long time, the theoretically correct claim that the rebalancing of the global imbalances should be part of the new world order has probably to be downgraded in the rank of priorities, at least in terms of timing. Capital will have to go on flowing from East to West for all the time necessary to let the Western economies restructure their private sector. Since twin deficits (surpluses) are a well established law of motion of the global economy, goods and services, too, will have to go on flowing along the same route. This is not to mean that the pre-crisis East-West imbalances can be grow again, but that their correction will have to keep the pace of the long-run correction of Western domestic fiscal deficits. A rush to external surpluses would, I am afraid, ignite a worldwide battle of beggar-thy-neighbour policies based on protectionism and competitive devaluations. The time is not ripe to force the leading Eastern governments to swallow their saving glut (if any) and to abandon their beloved export-led growth model.

Third, national, bilateral and multilateral institutions will have to be the key actors. In part, this will be natural given the nature of the resources to be dealt with and the disarray of financial markets. In part, some explicit arrangements will be necessary. The Chinese leaders, as is often the case, seem particularly forward looking. They are actively playing at all three levels: they are steering the domestic economy towards the most favourable position in the coming scenario; they are testing the US as a bilateral partner in the so-called G2, while they are also negotiating financial support to single Western governments against real assets (the hot case of Greece's debt *vis-à-vis* stakes in its port infrastructures is emblematic); finally, China has called for some non-trivial reforms of multilateral institutions and of the international payment system.

Fourth, for all this not to be like Sisyphus' Fatigue, a minimal requirement is that debt/GDP ratios should stop growing as soon as possible. Simple accounting tells us that to this effect governments should run a year primary surplus over GDP *st* such that (approximately)

$$s_t \geq d_{t\text{-}1}(i_t - \pi_t - g_t)$$

where *dt*-1 is the outstanding debt/GDP ratio, *it* is the nominal interest rate, *pit* is the inflation rate and *gt* is the growth rate. As is well known, the primary surplus is a measure of the real fiscal fatigue of the country, and this is bigger the larger is debt, and the higher is the (current) real interest rate relative to growth. Hence, low interest rates, inflation and growth, all relieve the fiscal fatigue. In order not to abuse of inflation, someone might evoke a world edition of the Stability and Growth Pact. This may in fact be an evocative idea, provided that, unlike the dead European antecedent, all three words are taken seriously and substantiated within the co-operative, multilateral framework that is being outlined here.

Fifth, in such a framework, central banks, too, will have to assume their own responsibility to the extent that they can control interest rates and inflation. This does not necessarily mean direct financing, or even bail out, of public debt (though the public opinion, if not some complacent insiders and economists, will not forget too quickly the amazing array of "unusual practices" that top central bankers have adopted to bail out private companies of dubious public interest). Yet the pre-crisis doctrine of total indifference towards (non-cooperation with) other institutions (domestic governments and foreign central banks) will have to be revised along with comfortably delimited views of the central bank's range of responsibilities and tasks with respect to economic and financial stability at large. And since fiscal and external deficits will have to be smoothly steered in parallel, without disrupting the underlying safety net of capital inflows, it seems necessary that leading central bankers will have to allocate some more attention and effort to exchange rates, uncovered interest parities and all that. The good old days of simple Taylor rules and inflation targets have gone.

A final thought goes to the "financial community" - financial companies, banks, brokers, dealers, etc., largely located in the leading financial centres in the Western hemisphere. Is there anything useful they can do? My immediate answer would be: please, do your business but do not disturb the drivers. Yet the financial community seems lulling itself with the idea of a quick and happy return to business as usual, with little cosmetic reforms, which basically means no drivers to be worried about. This attitude is dramatically incommensurate with the challenges ahead, and it further reveals the serious deficiency of vision and consciousness in which the financial world has fallen. If my analysis is correct, the world's chances to avoid the next crisis (one for which there would be no saviours left) involve a relocation of power from West to East and from markets to institutions. Markets and institutions are both necessary to govern a complex system that nobody knows and commands in its entirety (von Hayek). The right balance had been totally lost over the years leading to the present crisis, and it has to be restored. While Western institutions appear shy and confused in redesigning the governance of the world financial system, Eastern sovereign institutions appear definitely less so, since *they* have got the money and they want it to be *safe*. This may be sad, considering the nature of some of these institutions, but - as economists and businessmen are always eager to remind us - economic and political laws have no sentiments. The return to business as usual may turn out to be more of an illusion than a threat.

PERMALINK

Comments

Roberto,

Considering U.S. interest rates and taxes have been going down over a 30 year period, yet we still borrow to consume products made primarily from those same countries, were is sustainable growth going to come from now that rates are at zero?

How high can the debt go before we print like no tomorrow, or allow deflation and perhaps default?

Exiting to me is more than just these emergency measures.

hlowe
Reply to this commentBy Guest on 2009-12-17 17:47:09

What would be the full potential array of outcomes if the US federal government instituted a unbridled balanced budget amendment and stuck to the principle for multiple budget cycles?
Reply to this commentBy Guest on 2009-12-18 06:16:55

What might be the impact if the East cannot sustain economic growth without continous internal stimulus - and Western consumption continues to lag - and the West cannot sustain without financial/capital (debt) infusions from the East?

Could this in fact be unavoidable?
Reply to this commentBy Guest on 2009-12-18 07:51:13

I agree with all that the scenario I have drawn is far from being attractive, for at least two reasons. The first is that Western democracies will awake closely tied with, and dependent on, some Eastern authoritarian and non-democratic powers (after the nonsensical unilateralistic dream - or nightmare - of G. W. Bush). The second is that this scenario is certainly not the lasting solutions to our problems. However, I have tried to explain what I see as the least evil, not as the first best solution. The latter presently appears to me like an exercise of comparative statics with very little chance of successful dynamic transition.

RT
Reply to this commentBy Guest on 2010-01-13 10:59:28

Post A Comment

allowed html tags: a, b, i, u, blockquote

Name: Guest

Post anonymously

E-mail: (optional)

Confirmation: Keyword: egyea

By clicking Submit, you are agreeing to the RGE Blog Terms of Use.

PREVIEW SUBMIT

<< PREVIOUS POST

Progress on Global Warming is not yet in Evidence in Copenhagen
Jeffrey Frankel
Dec 16, 2009 9:10PM

NEXT POST >>

Economy Slowly Improving but Risks Posed by Weak Employment and Tight Credit Remain
John Graham and Kate O'Sullivan
Dec 18, 2009 1:09PM

Terms and Conditions Contact Us Jobs Roubini.com Help Center RGE Privacy Policy

Region:

Asia/Pacific Europe Latin America Middle East and Africa North America

Topics:

Macro View Markets Finance and Banking Geostrategic and Long Term Issues

EconoMonitors:

Nouriel Roubini's EconoMonitor RGE Analysts' EconoMonitor U.S. EconoMonitor Europe EconoMonitor Emerging Markets EconoMonitor Global Macro EconoMonitor Finance & Markets Monitor Asia EconoMonitor Latin America EconoMonitor Peterson Institute for International Economics Monitor