Déjà Vu All over Again: The Depressing Debate on the Financial Crisis and Democratic Politics

Wonhyuk Lim *Director of Global Economy Research, Korea Development Institute (KDI)*

The Great Depression and its sequels have shown that four interrelated challenges must be met to overcome an international financial crisis of significant scale: (1) securing access to a reserve currency to deal with "the original sin" of issuing debt in a currency not under one's own control; (2) shoring up aggregate demand in response to a deleveraging shock; (3) debt restructuring to resolve the stock of nonperforming loans and mitigate moral hazard; and (4) structural reform and adjustment to improve efficiency and realign prices and productivity levels. However, policy debates in the wake of the global financial crisis of 2008 have often displayed a depressing lack of awareness of the lessons from previous crises and reverted to "zombie ideas" for ideological or political reasons. Without a comprehensive understanding of the nature of the interrelated challenges, partial measures would be adopted in response to some aspect of the crisis to calm down the markets, but then a false sense of security would set in and pave the road for counterproductive measures that aggravate the situation, triggering another round of crisis. Unless a full set of policy measures are adopted to address the four interrelated challenges, this stop-and-go pattern will repeat itself.

Because the global financial crisis of 2008 originated in countries with reserve currencies (namely, the United States and Europe), the problem of "the original sin" was not fully appreciated until it became clear that the members of the eurozone could not, or would not, print euros the way the United States or the United Kingdom could issue dollars or pounds. The eurozone can deal with the original sin of borrowing in someone else's currency by making the European Central Bank (ECB) the lender of last resort for all eurozone countries, in return for ensuring economic reform and growth in these countries. The ECB made a clever move in this direction near the end of 2011 by making low-interest, three-year loans available to commercial banks through its long-term refinancing operation (LTRO) so that these banks could buy more sovereign debt. However, there is uncertainty as to whether this ad hoc measure can be extended and expanded. More fundamentally, if rising political and economic risks in the eurozone put more pressure on the sovereign debt of such countries as Spain and Italy, commercial banks taking on more of this sovereign debt would find their asset quality deteriorate, despite the liquidity relief provided by the ECB. To stem the tide, the ECB should consider buying sovereign debt directly from the secondary market across national boundaries as long as the interest rate remains above a level consistent with debt sustainability, which in turn is premised on economic reform and growth in crisis-stricken countries. In addition to making the ECB the lender of last resort, the eurozone countries should secure additional financial resources. The primary responsibility of dealing with the eurozone crisis must rest with the eurozone countries themselves. Financial contributions from the IMF and outside the eurozone should be supplementary, so as not to give the impression that the eurozone countries are trying to use other people's money to save the euro without risking their own money and changing their policies. The G-20, among others, must continue to exert peer pressure and insist that eurozone members increase their own war chest to deal with the risks of sovereign default.

Of the four interrelated challenges, the least well-understood and the most contentious one is that of shoring up aggregate demand in response to a

deleveraging shock, the main topic of academic and political debates on Keynesian economics. In the pre-crisis period, most mainstream macroeconomists supported the interest rate rule that targeted a low and stable level of core inflation, with little regard for asset prices. In hindsight, however, it now seems clear that the *appearance* of stable inflation and a stable output gap during the period of the "Great Moderation" concealed serious risks in the balance sheets of households, firms, and financial institutions. Faced with a low interest environment for a prolonged period, financial institutions engaged in imprudent lending and investment behavior, which pushed up asset prices but not consumer or producer prices. What might be called a deregulatory capture of financial supervision further encouraged this trend, by making it easier to leverage and avoid regulation. When a series of defaults on subprime mortgages and other businesses raised doubts about the underlying asset quality and debt sustainability of financial institutions, a sudden downward revision of acceptable leverage took place. How this "deleveraging shock" occurs when it does remains something of a mystery.

In response to the initial deleveraging shock, the G-20 successfully coordinated a macroeconomic expansion and launched the Mutual Assessment Process (MAP) to resolve global imbalances in 2008 and 2009. However, this initial response was not sustained. As soon as the financial Armageddon was averted and recovery got underway, policy debates shifted to fiscal consolidation, even though the bond market was signaling that the U.S. and other major advanced industrial nations had room to undertake aggressive fiscal expansion.

Proponents for fiscal consolidation regarded the global financial crisis as a severe recession, which could be cured in a short period through a large dose of easy money and "shovel-ready" projects. They believed that more proactive fiscal policy would be counterproductive given the lags in implementation. However, this focus on "shovel-ready" projects ignored the fact that a financial crisis triggered by a deleveraging shock is very different from a recession precipitated by a rate increase or a non-financial shock. In the case of a financial crisis, it would take a long time for highly indebted economic agents on their own to repair their balance sheets because their liabilities denominated in nominal terms remain the same whereas their asset values collapse after a deleveraging shock. Faced with the zero lower bound on the nominal interest rate, conventional monetary policy would have a limited effect and fiscal policy would have to step in to shore up aggregate demand.

Even in the face of continued deleveraging on the part of the overly indebted private sector and despite the lack of empirical evidence, many European countries adopted the idea of "expansionary contraction" in 2010. As indicated by the ongoing crisis in the eurozone and the double-dip recession in the United Kingdom, however, the idea of gaining market confidence through fiscal consolidation to produce an expansionary effect on output did not lead to the intended result.

A morality tale, oblivious to any discussion on aggregate demand, provided a rather different rationale for fiscal consolidation. According to this tale, the financial crisis was triggered by overconsumption, or living beyond one's means, and people should now tighten their belts and start living responsibly. Former U.S. Treasury Secretary Andrew Mellon, as quoted by President Herbert Hoover in his memoir, voiced this sentiment in the middle of the Great Depression. The secretary "had only one formula: 'liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate.'" Liquidation, according to Mellon, would "purge the rottenness out of the system; high costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted and enterprising people will pick up the wrecks from less competent people."

Yet another motive for fiscal consolidation was the desire on the part of small government advocates to "starve the beast" and dismantle what was left of the New Deal institutions. They saw a chance to push ahead with their deregulation agenda under the guise of fiscal rectitude when that agenda was

responsible for the onset of the crisis in the first place.

As far as debt restructuring is concerned, creditors and debtors have been engaged in a tug of war on cost sharing. In Europe, creditors claimed that fiscal irresponsibility in GIPSI (Greece, Ireland, Portugal, Spain and Italy) was the root cause of the eurozone crisis and prescribed austerity; however, they tended to ignore the fact that except for Greece, these countries had been held up as role models for fiscal improvement and rectitude in the pre-crisis period. By contrast, debtors pointed to the increasing current account imbalances since the launch of the euro and called for debt restructuring and symmetric adjustments.

This tug-of-war between creditors and debtors is a common feature in financial crises, but the desire to preserve the euro and the European project may eventually strengthen the bargaining position of debtors in this case. In international financial crises, such as the previous ones in Latin America and Asia, creditors backed by their governments and international financial institutions typically minimize their losses and impose adjustment costs on debtors. This in turn reinforces moral hazard on the part of creditors and provides support for the argument that *ex ante* restrictions on credit should be imposed to prevent crisis if *ex post* debt restructuring is not credible. In the ongoing eurozone crisis, however, there is a shared appreciation that the European project has helped to ensure peace and prosperity for Europe since World War II and that it would be a shame if this project falls apart due to a failure to agree on equitable burden sharing between creditors and debtors.

This sentiment also has important implications for the last of the four interrelated challenges. Although GIPSI countries have benefited from lower inflation and lower borrowing costs since joining the euro, they have forfeited their ability to adjust the exchange rate and must take drastic measures to realign price and productivity levels unless they are supported in their efforts by creditor countries' corresponding actions. Unless creditor countries provide support and reduce the need on the part of debtor countries to make nominal wage cuts and adopt austerity measures, their only option is to leave the euro with serious repercussions for the European project. Indeed, what is at risk is not only the interconnected financial system, but peace and prosperity in Europe. Those who side with the creditors and prescribe austerity for the debtors at all cost should be reminded that the suffering masses could make radical choices as was the case in the 1930s.

The eurozone countries should change their disastrous policies and mobilize their resources to meet the four interrelated challenges. The eurozone must deal with the "original sin" of borrowing in someone else's currency by making the European Central Bank the lender of last resort for all eurozone countries, in return for imposing sustainable reform and growth packages on these countries. The eurozone should scrap the idea of "expansionary contraction" and give priority to growth and employment. It would be helpful if macroeconomic expansion can be combined with investment and structural reform to improve productivity. Also, instead of making matters worse by continuing to perpetuate uncertainty about the magnitude of potential losses on the stock of nonperforming loans, the eurozone must agree on a clear debt restructuring strategy with a credible stress test for residual risks and a measure to mitigate moral hazard. For the flow dimension of the problem, the eurozone countries must rebalance by reducing price-productivity disparities, while maintaining the single currency. This international, intra-eurozone rebalancing would be easier if creditor countries adopt expansionary policies while debtor countries try to consolidate, rather than just forcing debtor countries to assume the entire burden of adjustment through austerity and deflation.

Recent elections in Europe, from Greece to France, have clearly shown that voters are no longer willing to put up with the austerity program which prescribes suffering for the masses while sparing the financial elite of any accountability. Popular

anger evident in the "Occupy Wall Street" movement is beginning to translate into substantive political outcomes. Creditor countries such as Germany are finally coming around to see the need for symmetric adjustments to realign price and productivity levels as well as to share costs for debt restructuring. Despite all the depressing debates on crisis management, democratic politics is forcing policymakers to move away from contraction and instead promote growth and employment. However, it remains to be seen how democratic politics will play out in the next few years. When the unemployment rate is over 20 percent and yet policymakers, under pressure from international creditors, continue to prescribe more suffering, politicians who call for radical solutions will gain more popularity. International creditors must realize it is in their own interest to take responsibility for their past investment decisions and work with the reformist center in debtor countries to keep extremist forces in check.