Penny-pinchers head for abyss

By Arthur Donner and Doug Peters
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"The best thing would be for Congress to pass a plan now that will reduce deficits when the economy is back to normal."

Christina Romer, former chair of President Barack Obama's Council of Economic Advisers, quoted in the Financial Times, Oct. 25.

Canada is minor player in an economic policy drama being played out in Europe and the United States, where the main actors are governments and central banks. Other players of note are consumers and businesses, with the financial sector occupying a key role in how the outcomes occur. And one would hope that this drama will dominate leaders' attention at the G20 meetings this week in Seoul, South Korea.

There is one central question: Can western economies grow at a sustainable growth rate and, at the same time, create meaningful numbers of jobs?

Obviously a positive outcome requires major private sector participation. But what will spur businesses to invest and hire? Our answer is: only increases in total demand worldwide.

Since the Great Recession ended in the middle of last year, deleveraging (paying down debts) has been the main priority of most Americans, Canadians and Europeans. But when everyone in the private sector simultaneously saves to repay debt, this weakens the economic recovery.

When companies deleverage, this means they are under-investing in capital equipment and in new jobs. When households reduce debts, they constrain their expenditures on consumer items as well as housing. The U.S. recovery is weak because there is too much saving at exactly the wrong time.

The new frugality in the private sector also explains why government spending has been the only positive game in town since the financial crisis spread from the United States to other countries in 2008.

The policy dilemma for governments and central banks is quite obvious. How do you stimulate an economy that is bent on saving to reduce debt?

Despite the fact that high unemployment is a major problem in the United States, Canada and Europe, there is adverse public reaction to increases in government debt and indebtedness. As a result, many western governments (particularly those facing capital market problems) are "talking up" their deficit reduction strategies.

However, this is exactly the wrong time to become preoccupied with high government deficits. Fortunately, the United States is less caught up in this hysteria, but the British coalition government recently announced a major austerity program.

When interest rates are close to zero (as they are in the U.S., U.K. and the euro area), monetary policy, while not completely ineffective, is close to toothless.

Economists describe this situation as akin to a liquidity trap. Yes, further quantitative easing (QE — printing money through expansion of the monetary base) helps in a liquidity trap but QE is no substitute for a vigorous new round of fiscal policy help.

We think that Bank of Canada governor Mark Carney was cagey in raising the Canadian overnight rate to 1 per cent in October. The increase hardly changed the low interest rate structure in Canada and likely was not a major deterrent to spending or investing. But it did provide the bank with the ability to spur the economy by lowering interest rates later, should it need to do so.

There is much to learn from Japan's recent experience with a liquidity trap. Japan's economy fell into a period of prolonged stagnation in the 1990s despite the presence of near-zero interest rates. Since interest rates could not fall below zero, Japanese monetary policy proved nearly impotent, as is the case today in the United States.

In Japan's liquidity-trap case, large government deficits didn't translate into either high inflation or high interest rates. The analogy with the U.S. may not be perfect, but it similarly implies that high U.S. government deficits will likely not escalate long-term bond rates because of fears over higher inflation. Indeed, the risks are entirely in the opposite direction, a deflation risk and low interest rates.

John Maynard Keynes pointed out in the 1930s that the most relevant policy instrument for creating and sustaining jobs in a liquidity trap is fiscal policy. Unfortunately, there is little hope of seeing a new round of fiscal stimulus in any of the G7 countries.

In a world awash with too much savings, the governments of the large economies need to run large fiscal deficits until the private sector (consumers and companies) are ready to spend again. Only when private sector spending is sustainable should governments stop running budget deficits.

When western economies are operating at strong and sustainable growth rates, deficits will automatically start falling and cuts to government spending will not hinder a continued economic recovery. Until that time, cuts to government spending will only delay the economic recovery.

The G20 summit meeting this week is important with respect to the outlook for the global economy. Considerable attention will, no doubt, focus on the American central bank's recent announcement of a second round of quantitative easing, which will likely weaken the U.S. dollar against the currencies of most of its trading partners.

But we hope that quantitative easing and currency issues do not sidetrack the leaders from addressing the real fundamental issue: The global recovery is weak because of too much savings and too rapid a pace of debt repayment by consumers and businesses.

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