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The bullets yet to be fired to stop the crisis

By Kenneth Rogoff

Four years into the financial crisis, it is becoming increasingly clear that the biggest deficit is not in credit, but credibility. Markets can adjust to a downgrade of global growth, but they cannot cope with a spiralling loss of confidence in leadership and a growing sense that policymakers are disconnected from reality. What needs to be done to move away from the precipice?

At the root of today's credibility deficit is a failure to come to grips with the long, slow growth period that is typical of post-financial crisis recovery. Too many decisions, for example the recent withdrawal of monetary stimulus by the European Central Bank and US Federal Reserves have been predicated on overly rosy growth projections. Time and again, policymakers counted on rapid post-crisis recovery to help them avoid painful decisions on how to deal with badly overstretched private and public balance sheets, whether household debts in the US or sovereign debts in the periphery of Europe. Time and again, rapid growth did not materialise or – if there was a burst – did not last. Every effort to delay a critical decision has ended unsatisfactorily. One is reminded of the *Peanuts* cartoon character Charlie Brown, who never seemed to figure out that his place holder Lucy would always pull the ball away at the last minute so as to enjoy watching him lose his balance. So the downturn has treated US and eurozone leaders, with each successive stumble further undermining their credibility.

By far the main problem is a huge overhang of debt that creates headwinds to faster normalisation of post-crisis growth – that is why post-financial crisis growth is typically very slow. It is better to think of the global economy as going through a "Second Great Contraction" (the Great Depression being the first) involving credit and housing, and not just output and unemployment.

Indeed, the question of whether the largest advanced economy regions are going to experience a double-dip recession is almost moot. For all intents and purposes, most European and US economies have never fully exited the downturn, with output per capita still below its pre-crisis peak.

Everyone agrees that bold action is required, but what kind of bold action? It is far from clear that any huge temporary fiscal stimulus will rev up the engine enough to achieve self-sustaining growth. Higher government debt adds an overhang of higher expected future taxes on top of pre-existing private debt overhang. True, in the classic analysis of a zero interest rate liquidity trap, the ideal policy is a money-financed temporary surge in government spending. But the canonical model completely ignores debt overhang.

The most direct remedy, of course, would be to find expeditious approaches to cleaning up balance sheets whilst maintaining the integrity of the financial system. In the case of Europe, this involves very large debt writedowns in the smaller periphery countries, combined with a German guarantee of central government debt in the rest. In return, Germany will have to receive a disproportionate share of fiscal power in a more deeply integrated union, for at least as long as it is making substantial transfers. In the case of the US, policymakers need to offer schemes to write down underwater mortgages, perhaps in return for other concessions such as giving the lender a share of any future home price appreciation.

If direct approaches to debt reduction are ruled out by political obstacles, there is still the option of trying to achieve some modest deleveraging through moderate inflation of say 4 to 6 per cent for several years. Any inflation above 2 per cent may seem anathema to those who still remember the anti-inflation wars of the 1970s and 1980s, but a once-in-75-year crisis calls for outside-the-box measures. Ideally, both the ECB and the Fed would engage in expansionary policy, as otherwise there could be profound exchange rate consequences. Of course, simply trying to stabilise exchange rates without overall monetary expansion – as the G7 seems to have proposed – is far less helpful.

Last but not least, monetary and financial solutions must be buttressed by structural reforms, including to unsustainable old-age pension and healthcare funds.

If policymakers can at least get the diagnosis right, it would be a major step on the road to recovery. After a long series of half-steps and mis-steps, policymakers' options are narrowing, but they are not out of bullets. Debt writedown schemes, temporarily elevated inflation and meaningful structural reform can still substantially shorten the normally long window of slow post-financial crisis growth.

At this critical juncture, leaders must not only get off the sidelines, but must finally address the problems of a Great Contraction – not a large but otherwise conventional recession.

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