Discussion: Deleveraging and Macroeconomic Adjustment

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1 Introduction

- Debt outcomes depend on past earnings, on potential earnings growth, and on decisions to spend, and on inherited stock of debt
  - During the great moderation earnings potential appeared much higher
  - It appeared that debt could be serviced
  - With the collapse of earnings potential this appears no longer possible

- Of course not all sectors can deleverage together – distinction between gross and net

- Deleveraging after a crisis is a process of returning to *normal* debt levels of borrowing and lending
  - Production funded by equity and borrowing
  - Private sector savings fund production, to enable pensions
  - Borrowing from Abroad to fund production which domestic savings will not fund
  - Public Debt borrows from future generations to public goods, and rises as a result of stabilization

- Deleveraging is almost always an *international* process

2 Insights from the 1920s and 1930s

2.1 *Keynes: The Economic Consequences of the Peace* (1919)

Keynes thought that Europe had worked the following way

- Rapid labour-saving technical progress and rapid labour force growth
- High savings rate
- This was an international system within Europe
- Moreover it was a global system:

Ideas relate to

the Ramsey model (1928)

the Lewis Model of the 1950s

This is a *real* story about economic growth.

The *Economic Consequences* identifies one way – a debt burden caused by reparations – which made this system break down.

Nevertheless the ‘psychology of society’ was such that there ‘grew around the non-consumption of the cake … instincts of puritanism…And so the cake increased [by means of capital accumulation]; but to what end was not contemplated… Individuals [were inclined] not so much to abstain as to defer’.

‘…the increasing pace of Germany gave her neighbours an outlet for their products, in exchange for which the enterprise of the German merchant supplied them with their chief requirements at a low price’

‘[t]he accumulative habits of Europe before the war were the necessary condition [for this growth]: …[o]f the surplus capital goods accumulated by Europe a substantial part was exported abroad, where its investment made possible the development of the new resources of food materials and transport, and enabled the Old World to stake out a claim on in the natural wealth and virgin potentialities of the New’

2.2 The Excess burden of the transfer

- An attempt to pay reparation will lead to a fall of the terms of trade and an excess burden (1929)
- But there are also *macroeconomic* difficulties

2.3 Debt and Macroeconomics

- The reparations provisions of the Treaty become a crucial impediment to growth .
- These helped to cause the German hyperinflation of 1922-23.
  - Whether the hyperinflation was caused by the need to finance reparation payments, or whether the link was indirect – in that the Germany deliberately postponed balancing the budget in the hope that the resulting chaos would cause the reparations to be renegotiated.
- The Dawes plan of 1924 led to US lending to Germany without dealing with the overall liability – the idea was to secure a schedule of payment, within which lending could be resumed, in the hope of an ultimate payment.
- This lending provided the basis for German recovery in the period from 1924 to 1928.
- Investment began to fall in 1928 and the growth process began to slow significantly
- This happened under the shadow of a lack of clarity about how the reparations would be dealt with.
- There is some similarity between what happened and the inability to write down the debt of peripheral Europe in present circumstances.

2.4 Adjustment Constraints

- Germany had returned to gold in 1924 – stabilising the new Reichsmark to the dollar at 4.20 to the dollar, an overvalued rate given the damage which had been done to the German economy by the war.
- France returned to the Gold standard in 1926, at a highly competitive exchange rate, enabling France to grow through exporting, but adopted contractionary policies in a way which limited the monetisation of the surplus.
- Britain emerged from the War without the capacity to sell enough to pay for its imports. Nevertheless there was a return to gold in 1925, at an exchange rate which most regard as about ten percent overvalued. The overvaluation of sterling and the high interest rates required to sustain it imposed a severe deflationary burden on the British economy. This is the most well known part of the story.
- The US was in a competitive position. The US in the 20s was highly competitive but was unable to adopt the policies which would have damped the stock market boom and the housing boom of the late 1920s. The congtractionary response of the US to the currency crises of 1931 in Europe caused the downturn to turn into a depression
- Put roughly the concern is that the gold standard caused policies in Germany and the UK - to be contractionary by 1930 – and prevented either adjustment in France or the damping of bust in the US in the early 1930s
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2.5 Overall Global Aggregate Demand

The gold standard did not contain within it a satisfactory mechanism for ensuring that the overall level of global aggregate demand was high enough.

- This is necessary for adjustment, which distributes demand across countries in a manner consistent with longer term solvency.
- The problem with the gold standard was not just that the *adjustment* mechanism between countries was at fault. That is, it was not just a difficulty in adjusting the *relative* costs and in the gold-standard system.

(ii) The drying up of the loans to Germany by 1928 which had begun under the Dawes plan further dampened demand.

(iii) The response of the US to the currency crises of 1931 in Europe caused the downturn to turn into a depression

(iv) The overhanging stock of debt made investment risky and so made it all the more difficult to sustain a level of demand which was adequate overall

Implications

Deleveraging can lead to crisis without either debt relief or the appropriate macroeconomic framework

2 Contrasts after two other crises

- The post World War II settlement
  - No imposition of a debt burden on Germany
    - Growth made possible by Marshall Plan
    - Adjustment made possible by Bretton Woods System
    - Deleveraging did not impede growth

- Post Asia crisis
  - Debt repayment made possible by means of huge current account surplus
  - Massive currency depreciation was the means that this was brought about
  - Deleveraging happened through growth

3 The Debt Burden in the Eurozone

3.1 The Supposed Framework - Growth and Integration

- Until 2008, the establishment of the Euro was successful.

High growth rates - high savings in the north, and rapid growth in the South.

- The ambition was a reunification of Europe. The growth framework has some similarity to that described by Keynes in 1919, both in relation to saving and to regional integration.

3.2 Debt

The idea was that the emerging markets in the South of the Eurozone would provide investment opportunities – integration of capital markets would enable risk premia to fall.

They fell, to zero, until 2007, and since have become very large.

- The economics of a solution requires:

(i) A mixture of further lending and debt writedown of sovereign debts and recapitalisation of banks

(ii) An adjustment of relative costs and expenditures
  - Both Germany and Southern Europeans must switch their expenditures toward Southern European goods,
    - Germany must also agree to enjoy its creditor position by loosening its fiscal position.
  - Southern goods must become *much* cheaper relative to German goods,
    - this is difficult and slow within a monetary union

(iii) Aggregate Eurozone expenditure maintained in a way which does not require an overall devaluation of the Euro relative to the dollar and the renminbi

- Growth cannot resume without both of the first two objectives being achieved. Pursuing growth by the third means will create difficulties for the world as a whole which take us beyond this discussion.

4 US and Japan

The US

- Deleveraging of financial institutions already significant after a crisis
- Deleveraging of public debt, along with adjustment, will require
  - Increase in investment –
  - Increase in net exports – points towards currency depreciation

Japan

- This is not deleveraging after a crisis
- Growth prospects are low – slow population growth
- Deleveraging of public debt, along with adjustment, will require
  - Increase in investment – difficult with slow growth
  - Increase in consumption – difficult with aging population
  - Increase in net exports – also points towards currency depreciation

5 Conclusion

- Deleveraging requires macroeconomic adjustment