Meltdown, Accommodating Monetary Policy and the Queen's Question

Keith Rankin, 7 March 2014

Yesterday I watched the final part of Al Jazeera's four-part series "Meltdown". The series raised some interesting issues, and noted in particular that our economic and financial behaviour has barely changed since the global financial crisis of the late 2000s. The programme suggested that, by and large, we do understand the causes of the crisis; and that the main problem therefore is converting our knowledge into appropriate political action. Otherwise, "five, ten or twenty years" after, another worse crisis will happen.

I disagree with the view that the causes of the crisis are well understood. And I also note that the general expectation is that governments must act to fix the problem. The reality is that governments cannot solve every problem of human nature; private citizens and corporations also need to try to understand these problems and, where necessary, modify their behaviour. I noted two weeks ago ("Global Savings Glut": http://www.scoop.co.nz/stories/HL1402/S00117/global-savings-glut.htm) that Sweden has become a part of the problem, not a part of the solution. But Swedes are good guys are they not? Do they really need to look into their mirrors, reflect on their misdeeds, and change their economic behaviours?

I am of the view that the next crisis – like the last one – will take the media, the politicians and most economists by surprise. When that conjuncture arises, the slickest of financiers will be less surprised, but they will have kept their inner concerns well hidden. Indeed, just because many banks and finance sector professionals behaved appallingly in the mid-2000s, it doesn't mean that that behaviour was actually the cause of the crisis. Banks were largely acting to accommodate a more deeply-seated problem. The global financial crisis occurred when the global financial sector came to the end of its ability to facilitate the accommodation of the massive credit imbalances which were for the most part not of their own making.

Financial Times journalist Martin Wolf observed that the global economy is a "very complex adaptive system". While this is certainly true, the key principles are not that complex, can be understood by just about anyone, and should be understood by many people other than intellectual economists.

I might note that two intellectual economists of interest are the University of Canterbury's Seamus Hogan and Eric Crampton. Their framework is unapologetically that of economic liberalism. And their blog is called "Offsetting Behaviour". Central to their view is that economic life is adaptive, accommodating, offsetting.

Liberal economics presents us with a quite simple adaptive system, derived from a set of core beliefs rather than derived from close observation of actual economic behaviour. Because liberal economics is derived from a belief system, it can quite reasonably be called 'theonomics'. Theonomics tells a lovely story; but it's a story that does not understand debt. And debt is absolutely central to actual real-world capitalism.

Liberal economics conceives of a fully private anthrosphere (human sphere) governed by rules that everybody obeys. The metaphor for Newton's planetary system was 'clockwork', and the metaphor for liberal economics was Newtonian mechanics, with the planets relentlessly following the laws of gravity. In liberal economics, the force of gravity becomes the force of individual rational self-interest. In pure liberal economics – laissez faire – sovereign governments are an unwelcome and costly intrusion. In a more nuanced version of laissez faire, governments, though still an intrusion, inject some benefits – law enforcement, pure public goods – as well as imposing costs. In this view, governments should be as small as possible; the extra benefit of additional government activity should never be allowed to exceed the allegedly high extra cost of additional government activity.

In economic liberalism's ideal world, unemployment is impossible and the sufficient accommodating mechanism is that of adjusting prices. Such prices include market wages, interest rates, and, in liberal economics' most recent incarnation, floating exchange rates. Government intrusions into such a fully self-correcting system are accommodated, typically through increased interest rates as a device for rationing investment funds. Thus while excessive government activity is seen as autonomous (the antonym of accommodating) and potentially destabilising, the theonomic price-mechanism responds in a way that is always stabilising. Thus the cost of escalating government activity is understood as inefficiency rather than instability.

It's a beautiful story, but it's part fantasy. Late in 2008, as Meltdown observed, the Queen gave an address at the London School of Economics. She discomforted her audience of PhDs with a simple question: "Why did you not see the financial crisis coming"? That was a constitutional sovereign at her most regal. Tellingly, the answer eventually given to the Queen was “a lack of imagination” on the part of the profession.

The problem is that our global and financial systems are accommodating, but in more accidental and less systemic ways than the apostles of economic liberalism suppose. And to a large extent it is governments that intentionally and unintentionally accommodate potentially destabilising private sector activity. To an even larger extent, it is commercial and central banks who facilitate the required offsetting behaviour.

At the core of the problem is our understanding of debt. Debt itself is not the problem. Accounting is the world's oldest profession (it created money, and money is the prerequisite for all other professions), and the debit side of the ledger is as central to capitalism as is the credit side.

Thrift, we are always told, is a virtue. But there are two kinds of thrift. The first kind of thrift, the good kind, is 'delayed gratification'. By going without goods or services today, we have more tomorrow. In the meantime the foregone output is advanced to and invested by the borrower, enabling more goods and services to be enjoyed by everyone tomorrow. Indeed that's liberal economics' benign story of credit.

The bad side of thrift is 'abstinence'; when saver-lenders produce more in their lifetimes than they ever intend to consume. When the time for delayed gratification arrives, these savers do not turn up to their own party. The extra goods and services produced for them remain unconsumed, the workers who the borrowers hired to produce them are fired, and the borrowers may become insolvent despite having upheld their side of the bargain. This bad thrift is otherwise known as 'miserliness'.

How does capitalism accommodate miserliness, given that miserliness is a common behavioural trait?

The principal mechanism is the financial system. Banks, for example, accommodate miserliness by recycling deposits and other bank liabilities as debt to the public. Here "the public" includes households, businesses, governments and other organisations. When the public resists taking on such debt, then the banks have to resort to a hard-sell approach. Bankers become much like other businesses; in the presence of miserliness they must advertise their abundant wares to scarce buyers. So long as they successfully 'sell' debt to the public, the economy remains strong, and generally fulfils its productive potential.

Thus it is those who incur or facilitate debt in these normal times who are stabilising the economic ship. Their actions offset the destabilising behaviour of the misers.

Most usually it is private borrowers who offset private creditors. Private parties – households and firms – incur debt often because people are by nature optimistic risk-takers. After all someone always wins the lottery, and you have to be in to win. We are aspirational. We are also suckers, easily susceptible to the charms of the marketing industry in general, and to real estate agents and bankers in particular. In Japan in the 1987-91 period, companies embarked upon an orgy of mainly speculative debt. It took them well over a decade to restore their balance sheets, and only then with the help of accommodating foreigners and an accommodating government.

Amongst the stabilisers are governments incurring Budget deficits; that is, governments accumulating evermore debt. Sometimes this government accumulation of debt is deliberate. At critical times governments may observe a resistance among private sector debtors to continue incurring debt; indeed they may observe increased private sector default. They understand – in line with the teachings of John Maynard Keynes – that governments must act in an accommodating debt-accumulating way when (and only when) private parties cannot or will not borrow to a sufficient extent. Such governments intentionally increase their spending, for example on public works, at precisely the times when they are at their weakest financially. Other governments incur extra debts simply by fulfilling their contractual obligations to their subjects.

An interesting example of accommodating debt, portrayed in Meltdown, is that of unoccupied offices and apartments in China. China's debt – partly private debt, partly government debt – is generally quite opaque to observers. Nevertheless in 2012, during a 10am solar eclipse over Shanghai, it was noted by Michael Pettis, an American professor teaching in China, that a large proportion of offices were unoccupied. Their lights were not switched on. While subsequent more comprehensive estimates confirmed that observation, they also revealed that 65 million apartments, mostly new, were unoccupied.

Meltdown also showed a complete town of uninhabited apartments south of Madrid in capitalist Spain. The billionaire developer absconded from Spain, when the financial crisis quickly converted those aspirational optimists into panicking pessimists. These buildings symbolise the goods and services that go unconsumed when the creditor-misers choose to not enjoy the delayed gratification that they contracted into.

What does the Reserve Bank do to accommodate global miserliness? The Reserve Bank of New Zealand is an unintentional accommodator. Under the illusion that inflation is a country's number one problem, and under the illusion that raising interest rates is a remedy for inflation, the Reserve Bank plans to raise interest rates this year. When it did this in 2004 to early 2008, it had no impact on inflation, but did do its own bit to accommodate the global savings glut.

This will happen again over the next few years. While the New Zealand government resists borrowing the savings of the world's misers, the Reserve Bank plans (albeit unintentionally) for private New Zealanders to do that instead. Its intervention will reinforce the accommodating price mechanism beloved by economists. New Zealand's private sector is already playing such an accommodating role. We know that because we see that New Zealand’s exchange rate is set at too high a level to achieve balance in its current account. And the financial community knows that it is relatively high interest rates set by central banks that cause countries to have over-valued exchange rates. Our interest rates serve as a welcome mat to foreign misers.

Essentially, higher interest rates suck more foreign debt into a country’s banking system, forcing banks to market that debt with increasing intensity. Increased borrowing to buy financial assets fuels speculative bubbles, and leads sellers of houses (and shares) to spend more than they otherwise would on consumer goods and services. And, during this accommodating phase of the financial cycle, mortgaged owners of houses borrow more, for consumption, on the security of the inflated values of their houses.

So long as New Zealand and a number of other countries maintain these erstwhile anti-inflationary policies, then the private sectors in these countries will accommodate the miserliness of others, and the world economy will continue to prosper as if nothing was wrong. Further, the liberal economists will tend to interpret this debt-funded spending as investment in new productive capacity, and therefore a benefit to world ‘economic growth’. Liberal economists see savers only as time-shifting spenders, never as misers.

Financial and economic crises occur when accommodation through debt suddenly ceases. Recovery occurs when new accommodators are found. The spending accommodation exemplified by the global housing boom of the mid-2000s came to a sudden end in 2008, following a few lurches in 2007. We got out of that crisis, not without grief to many creditors and workers, by governmental deficit accommodation until 2010. Then western governments abandoned their fiscal stimuli, threatening to send the world economy into a second recession in 2011, the equal of the 2009 recession. It was the stronger emerging economies, through a mix of government and private action, which then saved the world economy: Brazil, Russia, India, China (especially), Indonesia, South Africa, Argentina and Turkey were prominent in this regard. Australia also helped.

Now that these economies are coming to the end of their capacity to accommodate the global saving glut, it is the turn of economies like New Zealand, the United Kingdom and the United States to incur more private debt. (Note that in the 2003-08 period, the Anglo-American wars in Afghanistan and Iraq also played a substantial accommodating role, alongside the role played by American and British consumers.) The capacity of traditional western debtor economies to act as borrowers and spenders of last resort is more limited now, however. Further, because our offsetting behaviour that keeps the world economy ticking over is not understood to serve a higher purpose than consumerism, our behaviour could change at any time without our appreciating the global consequences. Storms can arise from what was a clear sky just an hour before.

It is not only in economics and finance that such storms arise. In July 1914, few people had any idea that almost the whole of Europe would be at war with itself that August. And, to this day, almost nobody can give a satisfactory explanation about why Britain (and, by proxy, New Zealand) got involved in that war. Then, one century later, how many of us until a week ago heard a single journalist warning that Russia might have a reason to detach Crimea from Ukraine? Yet, with hindsight, the recent incursions of Russian troops were entirely predictable.

The more specific answer to the Queen's question about economists' failure to predict the 2008 global crisis is that, so long as there are sufficient accommodating debtors in the world, everything seems to be normal. But that sense of normality can change very quickly, to the surprise of shallowly informed observers like most journalists and politicians, and to liberal economists whose belief premises assume that thrift is only of the 'delayed gratification' type, and that debt-funded investment is only constrained by high interest rates.

Global financial crises can be averted in four possible ways. If creditors– naively but conveniently – choose to believe that they can always be repaid, and so long as few creditors actually seek repayment, and so long as there continue to be parties willing to take-on and facilitate new debt on the requisite scale, then global financial crises can be indefinitely deferred. Second, misers, like Dickens' Scrooge and Margaret Atwood's "Scrooge Nouveau", might learn the errors of their ways, pay their taxes and, in their lifetimes, only earn the amount of income that they want to spend or give away.

The third way is through systemic inflation; this is the only way we know that gives what amount to negative interest rates. But it's surprisingly hard to achieve, as governments in the 1930s and more recently in Japan discovered. Finally, some kind of global 'debt jubilee' would be required. (Since medieval times, the closest we have ever come to a general cancellation of debts was World War 1 and World War 2. Economist advocates such as Steve Keen have more peaceful processes in mind; see "Debt Jubilee for New Zealand – The Great Reset" by Stephen Keys in *Scoop* in 2012; http://www.scoop.co.nz/stories/HL1204/S00101/debt-jubilee-for-new-zealand-the-great-reset.htm).

One final thought about monetary policy in the western world. My sense of history tells me that the Great Inflation of the 1970s and early 1980s was really two separate events. Prior to 1974, we had a classical inflation, which – in terms of my analysis here – could be classed as over-accommodation. Spenders outweighed savers, especially in the later years of the Vietnam War. Then, from 1975 global conditions quickly switched from being expansionary to being contractionary; savers outweighed spenders. At previous times in history, such conditions were associated with deflation, not inflation. But we didn't notice the switch in conditions, and the economic liberals were back in town. They only wanted to fight inflation.

My suggestion is that, from 1976 at least, the world's economic and financial leaders both misdiagnosed the problem and applied a remedy that had the opposite effect to what they believed it would have.

So, in my contrarian story, the world faced deflationary – not inflationary – conditions from 1975 to 1982. Monetary policies, at least from 1976 to 1982, were meant to be anti-inflationary, but were in fact anti-deflationary. The higher interest costs associated with those policies, while lowering inflation expectations, actually raised prices to levels higher than they would otherwise have been. Thus this first venture into monetarist policies since the 1920s was believed to have had a stabilising effect. Two wrongs may have created a right. Anti-deflationary policies that were believed to be anti-inflationary policies may have actually addressed a deflationary risk that we were not aware of.

The problem here, of course, is that fortuitously misapplied policies will not always have benign outcomes. The policy outcomes from the Milton Friedman influenced 1976-82 period were not actually benign, but in terms of eventually being followed by lower inflation rates, they were fortuitous from the point of view of the policy-makers concerned. It was, I suggest, the underlying contractionary conditions and not the monetarist policies that brought that inflationary episode to its end. Just as cargo cults arise because people misunderstand the relationship between coincident events, so our beliefs in what works can become entrenched by events that neither contradict nor prove the veracity of our beliefs.

When the Reserve Bank Governor Graeme Wheeler raises interest rates, probably on Thursday, he will be contributing to the recovery of the world economy. His actions will probably have no impact on the inflation rate.

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