The Other Half of Macroeconomics and the Fate of Globalization

Author: Richard C. Koo

Richard Koo's big idea is the theory of Balance Sheet Recession (BSR) and its impact on the long term development of an economy. This, he has dubbed as the 'other half of macroeconomics'. In his book, “The Other Half of Macroeconomics and the Fate of Globalization”, Richard Koo highlights the gaps in current day economics and suggests changes that are needed to make the profession relevant to the economic challenges of today. In the current times, when the liquidity taps seem to be running non-stop while economic growth continues to stagnate, the insights offered by this book can be highly instructive.

Key Takeaways:

- The way that central banks across the world have had to deal with the various economic crises in the last two decades requires economists to rethink traditional economics.
- For any economy to flourish, the interactions between the lenders and the borrowers need to be optimal i.e. enough lenders to match the needs of the existing borrowers.
- The above scenario is not always possible. There can be more lenders and less borrowers, more borrowers and fewer lenders or absence of lenders and borrowers.
- The main reason for a sub-optimal scenario is BSR and lack of investment opportunities.
- Over the long-run, capitalism has three stages: 1) urbanisation, 2) equilibrium and 3) pursuit
- Pursued economies can stay ahead of competition by being agile and innovative.
- The behaviour of economic agents and the effectiveness of macroeconomic policy, changes depending on the stage of economic development.

Landing into the 'other half’

The behaviour of lenders and borrowers in an economy can have a huge influence on economic growth and sustainability. The way lenders and borrowers behave can give rise to four possible outcomes.

1. Equally matched borrowers and lenders – this represents the standard textbook world, with 'ordinary' levels of interest rates.
2. Sufficient borrowers but not enough lenders due to bad loans – a financial crisis or credit crunch, with loan interest rates higher than the policy rate.
3. Sufficient lenders but not enough borrowers – a BSR or 'secular stagnation' with insufficient borrowers due to either balance sheet problems or a lack of investment opportunities, and very low interest rates.
4. An absence of both borrowers and lenders – this may occur in the aftermath of an asset-price bubble bust, with balance sheet problems and bad loans and very low interest rates. However, these rates would only be for highly rated borrowers.

The biggest challenges stem from points 3 and 4, which contain a shortage of borrowers. There are two main reasons why an economy can end up in the “other half” of macroeconomics with no private sector borrowers. The

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first is that borrowers might not be able to find attractive investment opportunities at home, and the second could be that their financial health has deteriorated to the point where they are unable to borrow until they repair their balance sheets. Currently, most countries in the world, especially the rich countries, are finding themselves in this predicament. The main reason for this is the presence of BSR and a lack of investment opportunities.

Japan, UK, or Europe have been in severe balance sheet recessions since their asset bubbles burst in 2008. Once the bubble bursts and households and businesses are left facing mounting debt, no amount of monetary easing by the central bank will persuade them to resume borrowing until their balance sheets are fully repaired. Through past experience one understands that when private-sector borrowers disappear, fiscal stimulus is absolutely essential in keeping the economy going.

The three stages of the long run development of capitalism

Stage 1: As a country industrialises and the rural population begins to migrate to urban areas in search of new employment, wages will tend to stagnate and profits will rise due to surplus rural labour. Additionally, urbanisation of the population will create significant investment opportunities especially in the infrastructure space as rural workers would need accommodation when they migrate to the cities to work in factories. Consequently, inequality rises and persists at these levels.

Stage 2: As the pace of urbanisation slows and surplus labour diminishes, wages and the bargaining power of labour rise and inequality falls. This situation was present in the US and Western Europe during the first twenty years or so of the post-war period in what is widely termed as the 'Golden Age of Capitalism'.

Stage 3: The newly emerging capitalist nations start to develop rapidly and catch up with the technological leaders. These countries now become the 'pursued' economies. An example of this is post-war Japan. This stage is marked by a fall in returns on investment in the leaders and stagnating wages, particularly for the lower skilled segments of the workforce. It leads to a rise in equality and a falling share of manufacturing employment. As a result, the supply of middle-income jobs for such workers shrinks.

Macro-economic policy challenges

The changes in the behaviour of businesses, workers, and consumers during the various stages of economic development have a strong impact on the monetary and fiscal policies of the respective governments due to their impact on economic growth and inflation. The importance and effectiveness of the fiscal policy, or government borrowing and spending, will depend on the stage of its economic development. In order to understand the unique macroeconomic policy challenges faced by pursued economies, it is useful to see how various sectors of the economy change as they go through the different stages of economic development. To stay ahead of the pursuers, the government needs to implement structural reforms in at least two areas. First, it must encourage innovation in the country to ensure that the country can remain at the forefront of the latest technological developments. This can be done by increasing the private return on innovation through a programme of tax cuts and deregulation, along with creating a liberal education system which produces independent thinking and its application to commerce. Second, it must become increasingly flexible and agile so that it can take quick action when the other countries try to overtake it. These are unique challenges for countries in the pursued state. The US has been relatively successful in implementing this when compared with Japan and some EU countries. The pursued economies in stage three will need to rely more on fiscal policy, so the government should borrow and spend on public investment projects which will crowd in private investment. This needs to be augmented with both funding and stimulating innovation. This would require an independent skilled commission to assess those areas where the social returns from public investment are greater than the cost. It is important to note that borrowing, whether by a firm or by the government, will only lead to an unsustainable rise in the debt burden if the social returns on the borrowed funds fall short of their cost. Any investment will make true economic sense only if the returns cover the costs.

On both issues, the U.S. experience in fending off Japan is instructive because it is the story of a country that lost its high-tech leadership. Tax and regulatory distortions are found in all countries, even though the source of the distortions may differ considerably. The ultimate goal of regulatory and tax reforms in pursued economies should be to minimize the time people spend on tax avoidance and to maximize the time they spend on productive activities that they are good at.

Helicopter money and the QE Trap

The use of helicopter money is an unconventional monetary policy tool that involves printing and distributing money to the public in an attempt to encourage people to spend money, thereby boosting the economy. The actual policies related to the use of this tool can be classified into four main types.

1. Dropping money from the sky

2. Direct financing of government deficits

3. Handing cash directly to consumers

4. Government scrip and perpetual zero-coupon bonds.

With the Japanese and European economies having difficulty reaching their inflation targets even after implementing negative interest rates and massive quantitative easing (QE), some people are now discussing the possibility of helicopter money. The dollar's strengthening can itself be seen as a manifestation of a global QE trap that began in response to the Fed's announcement of its intention to normalize interest rates. The Fed's official position on unwinding QE was that it would normalize its balance sheet first, and only then set about normalizing interest rates.

The backlash against globalisation and the case for reform

The emergence of extreme-right political parties and a louder call for inward looking policies in many countries has been alarming. Further, it is alarming to note that the current economic circumstances are very similar to those prevailing when similar groups had appeared in the 1930s. National Socialism or Nazism was a result of extreme economic hardship brought about by an inept policy response to a balance sheet recession. Fortunately for the U.S., policymakers from Ben Bernanke to Larry Summers recognized soon after the Global Financial Crisis (GFC) that they were facing a balance sheet recession, the same economic sickness that had afflicted Japan.

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In the U.S., Donald Trump, a complete outsider, was elected as a president because of his opposition to free trade and other establishment policies. He argued that while the World Trade Organization (WTO) framework may have been acceptable when the U.S. was economically dominant, it needed to be reconsidered now that the U.S. has lost that position. Both General Agreement on Tariffs and Trade (GATT) and WTO, which are at the heart of the postwar free-trade regime, are based on two fundamental principles: most-favoured-nation treatment and national treatment. Economists and financial market participants who lobbied for perennially free capital flows simply assumed that better allocation of resources would happen if the private sector was given more freedom. However, the rapid expansion of cross-border flows is making it difficult for central banks to implement monetary policy.

Rethinking economics

When conventional macroeconomic policies fail to produce the expected results then economists usually make the excuse of structural problems. The behaviour of economic agents and the effectiveness of macroeconomic policy is likely to change depending on the stage of economic development. There is a great deal of literature in economics on expectations, especially on inflationary expectations. A large number of economists and policymakers jumped onto the structural reform bandwagon in both post-1990 Japan and post-2008 Europe. Before the discovery of the other half of macroeconomics, economists had to come up with all sorts of explanations for phenomena they could not explain with their conventional framework, which is based on a profit-maximizing private sector. Economists are now looking at the current day challenges with a new lens.

As Richard Koo suggests, the reason why most countries are grappling with their economies is due to BSR and a lack of investment opportunities. One of the key attributes of a strong and growing economy is the presence of myriad investment opportunities. These opportunities need to be both in the form of fixed capital investment and financial market investments. For Indian investors, there are plenty of opportunities to explore in the financial markets. At the same time, there is good product side innovation to ensure that the needs of every kind of investor are met. One such innovative product innovation is the Systematic Investment Plan (SIP) vehicle that gives investors an opportunity to invest in the volatile equity markets in a measured and convenient manner. More recently, Mutual Funds have been strongly propagating the SIP vehicle for participating in the equity markets. Through a SIP, investors can reap the long-term benefits of equities while at the same time contribute to the economic growth of the country.