If we are to prevent another lost decade, we need macroeconomic policies to restore economic activity, and public investment to power sustained and productive growth.

Jeffry Frieden examines the continuing economic malaise in the developed world and argues that the immediate need in both Europe and the United States is for macroeconomic policies to help rekindle economic growth, and systematic plans to restructure household and sovereign debts. Without both, which entails a balancing act and opposition from powerful interests, we are headed for another lost decade.

The world is in the midst of the most serious economic crisis since the 1930s. Even more troubling, recovery from the Great Recession has been limited and halting. Europe is now in its second recession in five years, with skyrocketing unemployment in some countries and generalized stagnation in the region as a whole. The United States is doing better, but even there the improvement in economic conditions has been very weak.

This does not seem to be a typical cyclical recession – and it isn’t. As Menzie Chinn and I argue in our Lost Decades: The Making of America’s Debt Crisis and the Long Recovery, the world is suffering through a series of interrelated debt crises. And debt crises are different from cyclical recessions, for both economic and political reasons. We have already lost one decade to the current crisis, as the economic gains of the 2001-2007 have since been erased. If we are to avoid another lost decade, we need to understand how this crisis is different, and what can be done to limit its negative effects.

The crisis is the result of a decade of debt-financed consumption. In some countries, this was led by public-sector deficits. In other countries, borrowing was largely or entirely private. In virtually all cases, borrowing was not associated with increased investment but rather with increased consumption. This expansion of consumption led to a boom – especially in asset and housing markets – and then a bubble, which eventually burst.

Such a debt crisis leaves a difficult economic and political residue. On the economic front, it saddles society with a debt overhang that hampers recovery. Debtors reduce consumption and increase savings in order to mobilize resources for debt service. Creditors, encumbered with trillions in debts they know or fear to be bad, struggle to adjust their balance sheets to compensate for expected losses. It will be several years before we see American and European consumers spending in the usual ways, and before we see the American and European financial systems playing their appropriate role as intermediaries between savers and investors.

Politically, debt crises lead to conflict over the distribution of the adjustment burden. Among nations, creditor and debtor countries square off to see which will undertake the bulk of the costly adjustment: creditors demand debtor austerity to maintain debt service, while debtors demand a debt restructuring to make debts more manageable.

Within countries, conflict rages over who will be asked to contribute to deal with the debt overhang. In creditor countries, the question might be whether it will be financial institutions or taxpayers. In debtor countries, the issue is the distributional incidence of the austerity measures necessary to maintain debt service: taxpayers or beneficiaries of government services, workers or managers, the private or the public
sector. Debt crises always lead to substantial international and domestic political tension; the current crisis and its aftermath have been no exception.

The Western countries face serious economic and political problems – both short-term and long-term. In the short run, the overriding imperative is to rekindle economic growth. This almost certainly requires stimulative macroeconomic policies. So long as unemployment remains unacceptably high and recovery lags, governments should pursue aggressive monetary and fiscal policies to speed growth.

In addition, recovery requires a substantial restructuring of existing debts. It is in the interest of both creditors and debtors to find a resolution that allows a resumption of normal financial relations. Some debts can be restructured by negotiation. The current round of sovereign debt crises in Europe may fall into this category. However, most of the troubled debts today are of households, not sovereigns, and it is not feasible to renegotiate tens of millions of mortgages and other household obligations. This suggests a traditional way of reducing the real burden of accumulated debts: inflation. Several years of inflation in the 3-5 percent range would substantially reduce the extent to which debts foul the balance sheets of households in Europe and North America.

Whatever resolution is worked out will harm some more than others, which makes debt restructuring politically contentious. This can cause grave delays in settling the issue, and delay only raises the cost of a debt crisis. Both Europe and the United States find themselves embroiled in this dangerous tug of war.

The immediate need in both Europe and the United States is for stimulative macroeconomic policies to help rekindle economic growth, and systematic plans to restructure household and sovereign debts. Both sets of policies are highly controversial, involving as they do major conflicts of interests. But without both, the current recession is certain to lead to another lost decade as economies continue to stagnate and debts continue to hang over national economies.

There are also longer-term problems that Western governments need to address. Most OECD countries face serious fiscal choices over the next couple of decades. This is not a question of how much governments should spend on social insurance, the military, or education, but simply how they will pay for the things that voters want and are unwilling to see cut. For much of the past twenty years, governments have run deficits rather than fund their current expenditures, but deficit spending at these levels is unlikely to be feasible for the next twenty years. So one long-term problem is the need to find a way to square governments’ retirement and health-care commitments with their fiscal positions.

Future prosperity also depends upon expanding other important government programs. Economic growth in the developed countries will require substantial productivity advances, and this in turn requires a more highly skilled labor force, a more efficient economic infrastructure, and a more welcoming environment for technological innovation – all things that take money, including public money. However, the current political environment is not very favorable to dramatically increased spending.

If may well be economically or politically impossible to both sustain current levels of spending on social insurance, especially for retirement and health-care benefits, and increase spending on education and other productivity-enhancing public programs. We will undoubtedly have to make some hard choices along these lines – which implies that there are yet more political conflicts ahead.

Can the West avoid a second lost decade? It will be difficult, because the measures necessary to rekindle growth and make it sustainable will be resisted by powerful interests. In the short run, stagnant economies
need stimulative fiscal and monetary policies; but these will be opposed by those less affected by the crisis, as well as by wealthier taxpayers, creditors, savers, and those on fixed incomes. In the longer run, our economies need substantial public investments to improve our human and physical capital stock; but these will be opposed by those who want less government and lighter taxation.

If we are to stave off another lost decade, and to prepare for a better future, we need macroeconomic policies to restore acceptable levels of economic activity, and public investment to power sustained and productive growth. All dimensions require balance – balancing macroeconomic expansion with prudence, long-term growth with fiscal responsibility, and fiscal responsibility with social responsibility. The balancing act is not simple, and the opposition is powerful, but the stakes are very high.

Jeffry Frieden will be speaking at the Policy Network event ‘Lost or anew? American progressive-liberalism and European social democracy’ on 4 July at the LSE. More details.

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About the author

Jeffry Frieden – Harvard University

Jeffry Frieden is Stanfield Professor of International Peace, at HarvardUniversity’s Department of Government. He specializes in the politics of international monetary and financial relations.

He is the author (with Menzie Chinn) of Lost Decades: The Making of America’s Debt Crisis and the Long Recovery (2011), and of Global Capitalism: Its Fall and Rise in the Twentieth Century (2006), and is the editor or co-editor of over a dozen other books on related topics. His articles on the politics of international economic issues have appeared in a wide variety of scholarly and general-interest publications.

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