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Fostering a sustainable recovery in spite of 'preconditions': Five questions that need answering

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How will the global economy recover from the Covid-19 shock? Most observers wish for a rapid and sustained recovery and expansion. However, this wish is unlikely to be granted.

Prior to the pandemic, the global economy had 'preconditions' implying that it was already on an unsustainable path. While stocks of debt and greenhouse gases were rising continuously, towards ever more dangerous levels, the stocks of trust and political good will needed to achieve sustainable policy solutions were falling equally alarmingly. Growing economic and social disparities contributed materially to rising political tensions.

Introduction

Prior to the pandemic, the global economy had 'preconditions' implying that it was already on an unsustainable path. While stocks of debt and greenhouse gases were rising continuously, towards ever more dangerous levels, the stocks of trust and political good will needed to achieve sustainable policy solutions were falling equally alarmingly. Growing economic and social disparities contributed materially to rising political tensions.

Moreover, the public policies used to cushion the economic impact of the pandemic have in many respects aggravated the 'preconditions' problem. Paring back stimulus has become ever more necessary, but ever more likely to trigger future problems. The crisis has also affected poorer members of society disproportionately. To get off this bad path will require a 'total reset' rather than the incremental changes desired by those who wish to 'build back better'.

Fostering a sustainable recovery, in spite of such preconditions, requires answering five questions. First, what public policies have led us to the current unsustainable state of affairs – what I call 'policy preconditions' – and should be avoided in the future? Second, what future shocks threaten sustainable growth? Third, what would a more sustainable global economy look like? Fourth, what policies are required to get 'there from here'? Fifth, how do we – to use John Kenneth Galbraith's phrase – choose between the 'unpalatable' and the 'disastrous'?

My analysis emphasises the importance of monetary and fiscal policies in both shaping the recent path, and conditioning the future. However, interactions over time between the global economic system and the surrounding political and environmental framework are also crucially important. These interactions imply the need for policies with a much longer-term focus than hitherto. As well, it requires global political leaders able to rise to the challenge of choosing the 'unpalatable' over the 'disastrous'.

1: What 'policy preconditions' threaten sustainable growth?

Monetary policy has been the preferred countercyclical policy instrument since the 1980s. Each actual or anticipated slowdown was met with monetary easing. This was observed in 1987 (stock market crash), in the early 1990s (recession), later in the 1990s (Long-Term Capital Markets failure), 2000 (dot-com bubble burst and stock market crash), 2008 (North Atlantic credit bubble) and again in the response to the Covid-19 crisis. Against a backdrop of global disinflation, reflecting technological advances but especially the opening up of previously closed economies, interest rates never rose as much in recoveries as they fell in downturns. Thus, interest rates, both nominal and real, have ratcheted down towards zero in recent decades.

The growing reliance on monetary policy reflected the belief that fiscal policy could, in practice, never be used in a 'timely, targeted and temporary way'. In contrast, it was believed that monetary easing would always be effective in stimulating aggregated demand, and that it would have no meaningful unintended side effects. Unfortunately, both of these views about monetary policy are wrong. The longer run effects of policy changes matter enormously.

The effectiveness of monetary policy depends on future spending being brought forward, often accompanied by an increase in debt to finance spending. This works, but only for a limited time since the debt build-up restrains future spending. The 'headwinds' of debt have been steadily increasing in size and scope. At the end of 2019, the Institute for International Finance estimated that the ratio of global debt to global GDP had risen to 322 % ($255tn), 40 percentage points higher than at the onset of the 2008 crisis. Moreover, private sector borrowers in emerging markets made a significant contribution to this increase. Since the pandemic, sharp increases in corporate sector debt have been accompanied by sharp declines in GDP almost everywhere. This implies an even greater vulnerability to corporate debt overhang problems. In many countries, rising inequality implies that household debt is also increasingly burdensome as the poor become increasingly exposed.

As for other side effects, the business models of many financial institutions have been threatened by low intermediation margins. Pension funds and insurance companies, having the longest liabilities, have suffered the most, but even banks have raised concerns. Further, the 'search for yield' has exposed many institutions to losses should bets go bad. Mispriced markets (where prices could fall sharply) and malfunctioning markets (where liquidity suddenly dries up) also threaten the stability of the financial sector. These factors can also help explain resource misallocations, not least the growing number of 'zombie companies', with resulting effects on the level and perhaps even the rate of growth of potential. Finally, if low rates raise the prices of assets belonging mainly to the rich, this can become socially disruptive and politically destabilising.

If expansionary monetary policy seems increasingly unsustainable, so too is fiscal policy. Discretionary fiscal expansion and automatic stabilisers have interacted in successive downturns to constantly swell the ratio of public debt to GDP. Similar to monetary policy, the tightening in subsequent upturns has never been symmetrical. Public debt ratios have thus ratcheted up in recent decades to levels not previously seen outside of war time. Adding in off-balance sheet obligations and contingencies, governments in all advanced countries, even prior to the pandemic, could satisfy intertemporal balance sheet constraints only with significant tax increases. Record increases in deficits in the post-pandemic period have clearly made this problem worse.

The structure of both sovereign expenditures and taxes has been less than ideal. The proportion of government expenditures directed to investments with a longer run payoff (infrastructure, education, research and development) has been falling steadily. At the same time, transfers to support consumption have been rising. On the tax side, deductions that subsidise debt accumulation and the use of fossil fuels have also contributed to an unsustainable rate of growth for both debt and greenhouse gases. More generally, government policies have encouraged, or at least tolerated, excessive concentration in some industries and an excessive focus on near-term profits in others.

2: What future shocks threaten sustainable growth?

The 'policy preconditions' of debt, associated financial instability, rising inequality and resource misallocations could, in themselves, culminate in a deflationary spiral that would make the real burden of debt ever harder to bear. Unfortunately, we must also take into account other threats to sustained growth.

The future behaviour of the Covid-19 virus is itself a huge source of uncertainty. Basic epidemiological models suggest that infections will not cease, absent a vaccine, until 'herd immunity' is reached. This implies recurrent outbreaks and lockdowns that will constrain both demand and supply for an extended period.

Moreover, it is already clear that sectoral demand for goods and services will change massively. Relative prices, not least real estate, could change significantly while 'frictional unemployment' will rise with lower paid workers being most affected. Given the fragile state of the underlying economic conditions, both developments could easily get out of hand.

Prospective supply side developments also merit attention. The demographic dividend that drove real growth and disinflation in recent decades is now going into reverse. The skilled work force in both the advanced market economies and Asia is now declining absolutely.

Whether this negative supply shock will be matched by an equal decline in aggregate demand is a source of much debate. On balance, however, the outlook would seem more inflationary. The impact of digitalisation is also debatable. Some point to prospective, large increases in productivity. However, others fear further increases in corporate concentration and a further hollowing out of middle-class jobs in the advanced market economies in particular. This could exacerbate social and political problems arising from widening income inequality in many countries, as well as increased indebtedness as the poor borrow to 'keep up with the Jones's'.

Both the slowdown in international trade and global warming are unambiguously negative for future living standards. The former implies fewer productivity gains from the extension of global value-added chains. The latter will inflict huge damage from extreme weather events and the need to divert scarce resources to adapt the landscape to lower those costs. The costs of mitigating climate change are separate and will be treated below.

We must consider uncertainties about political outcomes. Surveys indicate that trust in both national political institutions and international engagements has been declining for many years. There is a growing body of academic literature that links financial crises, like the one that began in 2007, and growing inequality, to the erosion of support for governing parties in democratic countries.
Polarisation in favour of parties with nationalist agendas commonly follows, as we have seen in many advanced countries in recent years. Evidently, ideological barriers, like those now affecting Chinese-American relations, further reduce the likelihood of the multilateral cooperation required to deal with global threats to sustained growth.

3: What would a sustainable economy look like?

Continuing down the current path raises the likelihood of worsening economic crises that could threaten both the capitalist and democratic models. Given this dire prospect, alternative paths are worth considering. The first question is where we want the path to lead us. What would be the characteristics of a sustainable economic model?

The first requirement is for a paradigm shift in our analytical framework. The global economy would be recognised as a complex, adaptive system like many others in nature and society. Thinking in terms of systems, not silos as is currently the case, holds the key to a more sustainable world. Increasing sustainability includes building in more resilience, even at the cost of near-term efficiency and profits. Moreover, in spite of best efforts at structural change, all such systems break down regularly. Policy-makers would try to prepare ex ante for such outcomes, even those arising from unexpected sources. Finally, it would be recognised that the economic system is nested within interacting social, political and environmental systems. The sustainable development goals, developed by the United Nations, and the adoption of SDG criteria in evaluating investments, indicate a growing recognition of this reality.

A sustainable economic system requires a sustainable policy framework. The public sector, both finance ministries and central banks, would also conduct their policies more symmetrically over time to prevent ratcheting effects, particularly with respect to debt stocks. This would imply both more 'leaning against the wind' of credit upswings and more willingness to accept small economic downturns. Similarly, public sector safety nets would be more limited, to prevent moral hazard, and to protect taxpayers. There would be more disincentives to leverage and more incentives for risk-sharing across the private sector.

A sustainable system of capitalist production would adjust production costs and prices to reflect environmental and other externalities. Since complex systems like the environment have 'tipping points' beyond which uncontrollable processes are set in motion, the urgency of this requirement (e.g. imposing carbon taxes) should not be underestimated. Moreover, a sustainable system would be focused more on the interests of stakeholders rather than only shareholders. A greater focus by companies on sustainable profits over time, rather than meeting near term expectations, would also work in the same direction. With the exception of a few countries, economies would operate with higher levels of investment to GDP than has been observed in recent decades. Finally, antitrust legislation would be vigorously enforced to ensure the widespread distribution of economic benefits.

A sustainable, democratic political system requires more attention to distribution and social inclusion. Altered behaviour by private companies can help, but most governments would have to give this objective higher priority. Efforts to ensure equality of opportunity for younger people of different means would play a crucial role in such a world. Governments would also limit corporate influence in the drafting of legislation. Nothing threatens political legitimacy more than a popular belief that 'the system is rigged' against the interests of ordinary citizens.

Improved institutional structures are needed to ensure sustainability within and across the various systems that contribute to the global economy. Many problems are global, yet our global institutions are either lacking (we do not have an 'international monetary system') or are increasingly ineffective (vetoes at the United Nations), as nation states refuse to cede sovereignty. Moreover, urbanisation implies subnational poles of influence that are best placed to respond to local problems. Perhaps the best solution would be a 'barbell approach'. We need a globally shared 'vision' of how best to ensure sustainability, allied with 'execution' in a flexible and decentralised way by a variety of actors. This is essentially how the Paris climate agreement is meant to work. It also guides some of the thinking by the European Commission, approved by European leaders in July, on an ambitious new framework for European post-Covid-19 recovery.

4: What is needed to get from here to there?

If policy-makers accept that the global economy is a complex, adaptive system, this has many implications. Embracing complexity implies rejecting previous beliefs based on the idea that the economy is simple, understandable and therefore controllable. Maximisation in complex systems is beyond our capacities. Therefore, policy-makers should begin to concentrate on efforts to minimise truly bad outcomes. Similarly, precise forecasting is impossible, and alternative scenarios should replace forecasts. Indicators of growing systemic stress should dominate the search for 'triggers', since almost any development could trigger a crisis in a heavily stressed system. Finally, multiple indicators of stress should replace the single indicators (like price stability) currently favoured by policy-makers.

Accepting that Covid-19 will pose a significant threat to human health until 'herd immunity' is achieved (or a vaccine is developed) also has significant policy implications. Absent a vaccine, this belief implies a certain number of deaths are inevitable. The only advantage of 'social distancing' is to slow the rate of infections to a level that the health system can cope with. Given the economic, social and even health costs (e.g. missed diagnoses and treatments) of 'social distancing', this implies returning to normal as quickly as possible, subject to the proviso that the health care system can continue to cope. This conclusion is reinforced by the realisation that the longer the current crisis continues, the greater the likelihood that the 'policy preconditions' will tip the current recession into something even worse.

Getting to a sustainable policy framework will also require dealing with the 'policy preconditions'. The first priority must be to restructure the debts of the overburdened, obviously with a bias to maintaining businesses as ongoing concerns. 'Zombie companies' should be identified and resolved. Great care should also be taken not to provide state support, during the pandemic, to companies whose current business model will not be viable in the sustainable economy envisaged. In many countries, legal and administrative procedures will have to be strengthened to do this in an orderly way. Private sector debt and the sovereign debt of poorer countries should be most affected. In turn, this could require recapitalisation of financial institutions, with potentially significant implications for the fiscal position of many governments. As well, other measures should be taken to support the stability of the financial sector.

The next priority must be to 'normalise' monetary policy. The current stance of policy is doing more harm than good and this should be moderated as soon as possible. However, the possibility of a 'temper tantrum' in financial markets has the potential to cause significant damage, given current overvaluations, and so any tightening will have to be done very carefully. The likelihood and the economic costs of such disorderly developments would be reduced to the extent that necessary debt restructuring had already taken place in an orderly way, as suggested above.

Fiscal deficits in many countries are adding to sovereign debt levels and making that 'policy precondition' worse, not better. Nevertheless, this stance should be maintained until the economy seems to be recovering sustainably or until signs begin to emerge that market access is under threat. Current interest rates indicate that most countries still have significant room for more borrowing. They should do so at the longest duration possible, to push concerns about debt servicing capacities far off into the future. Efforts to convince markets of their firm intention to reduce sovereign debt ratios, once economic stability had been restored, would also be very helpful.

Paying more attention to distributional issues and social inclusion (to help avoid political instability) will involve significant changes to private sector compensation practices. Higher wages and improved security for the lowest paid should be offset by squeezing the total compensation of those at the top. Government safety nets should be increasingly directed to individuals, rather than companies and specific industrial sectors. Job-related education and training, as well as active labour market policies to assist job-seeking, will all need to be improved.

Moving to a more sustainable production system will involve costly measures with implications for financial stability. Respecting the global 'carbon budget', consistent with agreed targets for global warming, implies recognising trillions of dollars worth of 'stranded assets' and this poses a potential threat to financial stability. Moreover, refocusing attention on the interests of stakeholders rather than just shareholders, and the interests of consumers as well as producers, could have important implications for equity valuations. Raising investment levels, not least for green infrastructure, could eventually put strains on production capacity. This would raise the likelihood of inflation, the need for a monetary response, and the likelihood of a disorderly market reaction.

Moving to a 'barbell' institutional structure demands that nation states cede some of their powers to both supranational and subnational institutions. Attempts to retain such powers, even as other institutions claim them, risks a growing complexity that will eventually increase the chance of systemic breakdown.

5: How can we make the right political choice between 'unpalatable' and 'disastrous'?

It is not hard to imagine that the current global economic path will end in disaster. Galbraith's quip therefore remains pertinent: 'Politics is not the art of the possible. It is choosing between the unpalatable and the disastrous'. Unfortunately, all the changes required to avoid the latter outcome involve large costs, either economic or to cherished beliefs, and are therefore unpalatable. Moreover, most of the economic costs are likely to fall on the richer parts of society, who might be tempted (and have the means) to resist this outcome. The pushback on the recent G20 suggestion, that private sector creditors should participate in debt relief for the poorest emerging market countries, is indicative of bigger battles still to come.

The 'preconditions' of debt and potential financial instability, together with the other shocks threatening sustainable growth, imply disinflationary global pressures over the foreseeable future. In the light of recent experience, post-2008 and particularly in response to the pandemic, a likely outcome is that monetary and fiscal authorities will 'double down' on expansionary policies. In effect, this presages a further expansion of government debt financed by central banks. Political leaders, especially those subject to near-term elections, will accede to this as the 'least cost' solution for them personally.

Encouraging this policy, similar policies to date have not in practice culminated in disaster, even in Japan where they have been pursued most vigorously. As well, 'modern monetary theory' will provide analytical support. It suggests that there are no limits to such policies other than the eventual threat of rising inflation which, in any event, can be easily controlled. Those who, nevertheless, continue to worry about further increases in debt ratios and associated financial instability, will be offered solace in the possibility of 'financial repression'. If the growth of aggregate demand can be stimulated, while interest rates are held down by some combination of monetary policy and administrative controls, debt service ratios will eventually decline to more comfortable levels. Such a policy worked in the aftermath of the second world war. Increasingly serious consideration of 'yield curve control' by central banks is consistent with such a strategy.

'Doubling down' on macroeconomic stimulus and 'financial repression' might succeed in pushing off an eventual economic crisis for a few years. Yet, it would further aggravate the 'preconditions' problem and leave in place growing threats to environmental and political sustainability. Moreover, the strategy might not succeed. If monetary policy has lost its effectiveness in stimulating aggregate demand, will fiscal stimulus suffice? Have all of the problems of conducting 'timely, targeted and temporary' fiscal policies really been overcome? In a modern economy, can administrative measures (presumably including capital controls) succeed in keeping down interest rates down even as aggregate spending increases?

The greatest danger posed by this strategy is that 'fiscal dominance' eventually undermines confidence in the capacity of central banks to resist increases in inflation and inflationary expectations. The likelihood of this happening is increased if the basic assumption behind 'doubling down' is proved wrong. As noted above, there are in fact a number of reasons why inflation might soon revive. Indeed, monetary tightening in response could even raise the fears of fiscal dominance if higher rates increased significantly the government's debt service requirements. Moreover, the transition from a disinflationary state to a highly inflationary one could be rapid and initially uncontrollable. Such processes, often culminating in hyperinflation, have been seen many times historically and are in fact typical of complex, adaptive systems.

This 'disastrous' possibility reinforces the arguments for choosing the 'unpalatable' policy alternatives still available.

There is no alternative to refashioning the system so as to alter the fiscal-monetary balance, place greater emphasis on sustainability, and improve the framework for distribution and social inclusion.

This will involve difficult tasks like debt write-offs, navigating a gradual retreat from unsustainable monetary and fiscal policies, and a 'barbell approach' dividing up national and international responsibilities.

International agreement on what needs to be done to avoid disaster would be a big step forward. However, an even bigger challenge, but one that cannot be shirked, is to find the political leadership to implement essential change in the face of vested interests and potentially an unsupportive public.

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