Mervyn King’s credentials don’t generate much expectation that his new book would provide an insightful read. After all, retired senior civil servants rarely bite the hands that fed them well. Besides, King, who until 2013 was the governor of the Bank of England (the U.K.’s Federal Reserve), has been widely criticized for doing too little to prevent Britain’s financial meltdown in 2008 and, after the fact, for moving too slowly to repair the damage. Thus, one might have expected *The End of Alchemy* to be a tell-little defense of his role – one that added modestly to what we already knew. ¶ In fact, the book is full of surprises. It’s a take-no-prisoners analysis of the failure of the global banking system and a call for radical change. And did I mention that King is a master at explaining complex economics to non-experts without the slightest hint of condescension? ¶ Here, we’ve reprinted the chapter in which Baron King of Lothbury (in the U.K., the fate of retired government technocrats seems to be life peerages rather than seven-figure consultant gigs) explains the depths of the mess created by the rigidity of monetary union in Europe and the desperate need for debt relief on the part of the union’s creditor nations. —Peter Passell
What experience and history teach us is that people and governments have never learned anything from history, or acted on principles deduced from it.

—Georg Wilhelm Friedrich Hegel, *Lectures on the Philosophy of History* (1832)

In earlier chapters I dwelled on past crises. But what about the next crisis? Without reform of the financial system, another crisis is certain, and the failure to tackle the disequilibrium in the world economy makes it likely that it will come sooner rather than later. Rather than give in to pessimism, however, we have the opportunity to do something about it.

The most obvious symptom of the current disequilibrium is the extraordinarily low level of interest rates that, since the crisis, have fallen further. The consequences have been further rises in asset prices and a desperate search for yield as investors, from individuals to insurance companies, realize that the current return on their investments is inadequate to support their spending needs. Central banks are trapped into a policy of low interest rates because of the continuing belief that the solution to weak demand is further monetary stimulus. They are in a prisoner’s dilemma: if any one of them were to raise interest rates, they would risk a slowing of growth and possibly another downturn.

When interest rates were cut almost to zero at the height of the crisis, no one expected that they would still be at those emergency levels more than six years later. A long period of zero interest rates is unprecedented. For much of the post-war period the worry was that interest rates might be too high. Now the concern is that low rates are eroding savings. It is reminiscent of Walter Bagehot’s maxim about the archetypal Englishman: “John Bull can stand many things, but he cannot stand 2 percent.” For more than six years now, he has had to stand rates well below that.

From its foundation in 1694 until 315 years later in 2009, the Bank of England never set the bank rate below 2 percent. By 2015, the major central banks had all lowered official policy rates to as close to zero it made no difference; a number of European economies, including the euro area, Denmark, Sweden and Switzerland, had embraced negative interest rates. Some mortgage borrowers on floating rates were actually being paid to borrow. Over the long sweep of history, the long-term annual real rate of interest has averaged between 3 and 4 percent. The world real interest rate on 10-year inflation-protected government bonds has been close to zero for several years, and by 2015 was little more than 0.5 percent. In part that reflects the belief that short-term official interest rates will remain low for a few years more.

**WHAT DOES THE MARKET THINK WILL HAPPEN?**

Suppose it takes 10 years to get back to somewhere close to normal, a pessimistic view according to most central banks. What is the market expectation today of where the 10-year real interest rate will be 10 years from now? An estimate of that can be made by noting that the interest rate today on a 20-year security is the average of the rate over the first 10 years (the rate today on a 10-year security) and the rate over the second 10 years (the 10-year rate that is expected today to prevail 10
years from now). So we can infer the latter from observations on market interest rates on 10- and 20-year index-linked government bonds. Such a calculation reveals that the 10-year real rate expected in 10 years’ time has averaged little more than 1 percent in recent years and by late 2015 was still below 1.5 percent, well below any level that could be considered remotely “normal.” Markets do not expect interest rates to return to normal for many years.

If real interest rates remain close to zero, the disequilibrium in spending and saving will continue and the ultimate adjustment to a new equilibrium will be all the more painful. If real interest rates start to move back to more normal levels, markets will reassess their view of the future and asset prices could fall sharply. Neither prospect suggests a smooth and gradual return to a stable path for the economy. Further turbulence in the world economy, and quite possibly another crisis, are to be expected.

The epicenter of the next financial earthquake is as hard to predict as a geological earthquake. It is unlikely to be among banks in New York or London, where the aftershocks of 2008 have led to efforts to improve the resilience of the financial system. But there are many places where the underlying forces of the disequilibrium in their economies could lead to cracks in the surface – emerging markets that have increased indebtedness, the euro area with its fault lines, China with a financial sector facing large losses, and the Middle and Near East with a rise in political tensions.

Since the end of the immediate banking crisis in 2009, recovery has been anemic at best. By late 2015, the world recovery had been slower than predicted by policymakers, and central banks had postponed the inevitable rise in interest rates for longer than had seemed either possible or likely. There was a continuing shortfall of demand and output from their pre-crisis trend path of close to 15 percent. Stagnation – in the sense of output remaining persistently below its previously anticipated path – had once again become synonymous with the word capitalism. Lost output and employment of such magnitude has revealed the true cost of the crisis and shaken confidence in our understanding of how economies behave. How might we restore growth, and what could happen if we don’t?

Lost output and employment of such magnitude have revealed the true cost of the crisis and shaken confidence in our understanding of how economies behave.

SOVEREIGN DEBT FORGIVENESS

Maintaining interest rates at extraordinarily low levels for years on end has contributed to the rise in asset prices and the increase in debt. Debt has now reached a level where it is a drag on the willingness to spend and likely to be the trigger for a future crisis. The main risks come from the prospect of a fall in asset prices as interest rates return to normal levels, and the writing down of the value of investments as banks and companies start to reflect economic reality in their balance sheets. In both cases, a wave of defaults might lead to corporate failures and household bankruptcies.

By 2015, corporate debt defaults in the industrial and emerging market economies were rising. Disruptive though a wave of defaults would be in the short run, it might enable a “reboot” of the economy so that it could grow in a more sustainable and balanced way. External debt – debt owed by residents of one country to residents of another country – is
more difficult, especially when that debt is denominated in a foreign currency.

When exchange rates are free to move, they reflect the underlying circumstances of different economies. Some governments, such as China in relation to the U.S. dollar and Germany in relation to its European neighbors, have limited that freedom so that economies have had to adapt to exchange rates rather than the other way round. As a result, trade surpluses and deficits have also contributed to the build-up of debts and credits that now threaten countries’ abilities to maintain full employment at current exchange rates. Nowhere is this more evident than in the euro area, although emerging market economies could also run into trouble. Sovereign debts are likely to be a major headache for the world in the years to come, both in emerging markets and in the euro area. Should these debts be forgiven?

The situation in Greece encapsulates the problems of external indebtedness in a monetary union. GDP in Greece has collapsed by more than the percentage drop in the United States during the Great Depression. Despite an enormous fiscal contraction bringing the budget deficit down from around 12 percent of GDP in 2010 to below 3 percent in 2014, the ratio of government debt to GDP has continued to rise, and is now almost 200 percent.

All of this debt is denominated in a currency that is likely to rise in value relative to Greek incomes. Market interest rates are extremely high and Greece has little access to international capital markets. When debt was restructured in 2012, private sector creditors were bailed out. Most Greek debt is now owed to public-sector institutions, such as the European Central Bank, other member countries of the euro area and the IMF. Fiscal austerity has proved self-defeating because the exchange rate could not fall to stimulate trade. In their 1980s debt crisis, Latin American countries found a route to economic growth only when they were able to move out from under the shadow of an extraordinary burden of debt owed to foreigners. To put it another way, there is very little chance now that Greece will be able to repay its sovereign debt. And the longer the austerity program continues, the worse becomes the ability of Greece to repay.

Much of what happened in Greece is reminiscent of an earlier episode: in 1991, Argentina fixed the exchange rate of its currency,
the peso, to the U.S. dollar. It had implemented a raft of reforms in the 1990s, and was often cited as a model economy. At the end of the 1990s, there was a sharp drop in commodity prices and Argentina went into recession.

Locked into a fixed-rate regime, the real exchange rate had become too high, and the only way to improve competitiveness was through a depression that reduced domestic wages and prices. Argentina’s debt position was akin to that of Greece, and it had a similarly high unemployment rate. So in the face of a deep depression, the exchange rate regime was abandoned and capital controls were introduced. Bank accounts were redenominated in new pesos, imposing substantial losses on account holders. Initially, the chaos led to a 10 percent drop in GDP during 2002. But after the initial turmoil, Argentina was able to return to a period of economic growth. Commodity prices rose steadily for a decade and Argentina was able to enjoy rapid growth of GDP – almost 10 percent a year for five years.

It is evident, as it has been for a very long while, that the only way forward for Greece is to default on (or be forgiven) a substantial proportion of its debt and to devalue its currency so that exports and the substitution of domestic products for imports can compensate for the depressing effects of the fiscal contraction imposed to date. Structural reforms would help ease the transition, but such reforms will be effective only if they are adopted by decisions of the Greek people rather than being imposed as external conditions by the IMF or the European Commission. The lack of trust between Greece and its creditors means that public recognition of the underlying reality is some way off.

The inevitability of restructuring Greek debt means that taxpayers in Germany and elsewhere will have to absorb substantial losses. It was more than a little depressing to see the countries of the euro area haggling over how much to lend to Greece so that it would be able to pay them back some of the earlier loans. Such a circular flow of payments made little difference to the health, or lack of it, of the Greek economy. It is particularly unfortunate that Germany seemed to have forgotten its own history.

At the end of the World War I, the Treaty of Versailles imposed reparations on the defeated nations – primarily Germany, but also Austria, Hungary, Bulgaria and Turkey. Some of the required payments were made in kind (for example, coal and livestock), but in the case of Germany most payments were to be in the form of gold or foreign currency. The Reparations Commission set an initial figure of 132 billion gold marks. Frustrated by Germany’s foot-dragging in making payments, France and Belgium occupied the Ruhr in January 1923, allegedly to enforce payment. That led to an agreement among the Allies – the Dawes Plan of 1924 – that restructured and reduced the burden of reparations. But even those payments were being financed by borrowing from overseas, an unsustainable position. So a new conference met in the spring of 1929 and after four months of wrangling produced the Young Plan, signed in Paris in June at the Hotel George V, which further lowered the total payment to 112 billion marks and extended the period of repayment to expire in 1988. But the economic reality was that, unless Germany could obtain an export surplus, its only method of financing payments of reparations was borrowing from overseas.
In May 1931, the failure of the Austrian bank Creditanstalt led to a crisis of the Austrian and German banking systems, and a month later the Hoover Moratorium suspended reparations. They were largely cancelled altogether at the Lausanne conference in 1932. In all, Germany paid less than 21 billion marks, much of which was financed by overseas borrowing on which Germany subsequently defaulted.

After the Versailles Treaty was signed, Keynes and others argued that to demand substantial reparations from Germany would be counterproductive, leading to a collapse of the mark and of the German economy, damaging the wider European economy in the process. But the most compelling statement of Germany’s predicament came from its central bank governor, Hjalmar Schacht. In 1934, writing in that most respectable and most American of publications, *Foreign Affairs*, Schacht explained that “a debtor country can pay only when it has earned a surplus on its balance of trade, and … the attack on German exports by means of tariffs, quotas, boycotts, etc., achieves the opposite result.” Not a man to question his own judgments (the English version of his autobiography was titled *My First Seventy-six Years*, although sadly a second volume never appeared), on this occasion Schacht was unquestionably correct. As he wrote in his memoirs about a visit to Paris in January 1924:

> It took another eight years before the Allied politicians realized that the whole policy of reparations was an economic evil which was bound to inflict the utmost injury not only upon Germany but upon the Allied nations as well. Of the 120 milliards [billions] which Germany was supposed to pay, between 10 and 12 milliards were actually paid during the years 1924 to 1932. And they were not paid out of surplus exports as they should have been. During those eight years Germany never achieved any surplus exports. Rather they were paid out of the proceeds of loans which other countries, acting under a complete misapprehension as to Germany’s resources, pressed upon her to such an extent that in 1931 it transpired that she could no longer meet even the interest on them. Finally, in 1932, there followed the Lausanne Conference at which the reparations commitments were practically written off.

After World War II, and with Germany divided, the problem of German debt reared its ugly head again. In 1953, the London Agreement on German External Debts rescheduled and restructured the debts of the new Federal Republic of Germany. Repayment of some of the debts incurred by the whole of Germany was made conditional on the country’s reunification. In 1990 the condition was triggered and on 3 October 2010 a final payment of German war debts of €69.9 million was made.

More interesting from today’s perspective is the statement in the agreement that West Germany would have to make repayments only when it was running a trade surplus, and the repayments were limited to 3 percent of export earnings. The euro area could learn from this experience. One way of easing the financing problems of the periphery countries would be to postpone repayment of external debts to other member countries of the euro area until the debtor country had achieved an export surplus, creating an incentive for creditors and debtors to work together to reduce trade imbalances.

It is deeply ironic that today it is Germany that is insisting on repayments of debt from countries that are unable to earn an export surplus, out of which
that is insisting on repayments of debt from countries that are unable to earn an export surplus, out of which their external debts could be serviced, because of the constraints of monetary union. Schacht must be turning in his grave.

As the periphery countries of southern Europe embark on the long and slow journey back to full employment, their external deficits will start to widen again, and it is far from clear how existing external debt, let alone any new borrowing from abroad, can be repaid. Inflows of private-sector capital helped the euro area survive after 2012, but they are most unlikely to continue forever. It is instructive to quote Keynes’ analysis in the interwar period, replacing Germany in 1922 with Greece in 2015, and France then with Germany today:

The idea that the rest of the world is going to lend to Greece, for her to hand over to Germany, about 100 percent of their liquid savings – for that is what it amounts to – is utterly preposterous. And the sooner we get that into our heads the better.

Much of the euro area has either created or gone along with the illusion that creditor countries will always be repaid. When a debtor country has difficulties in repaying, the answer is to “extend and pretend” by lengthening the repayment period and valuing the assets represented by the loans at face value. It is a familiar tactic of banks unwilling to face up to losses on bad loans, and it has crept into sovereign lending. To misquote Samuel Taylor Coleridge (in his poem The Rime of the Ancient Mariner), “Debtors, debtors everywhere, and not a loss in sight.”

Debt forgiveness is more natural within a political union. But with different political histories and traditions, a move to political union is unlikely to be achieved quickly through popular support. Put bluntly, monetary union has created a conflict between a centralized elite on the one hand, and the forces of democracy at the national level on the other.

This is extraordinarily dangerous. In 2015, the presidents of the European Commission, the Euro Summit, the Eurogroup, the European Central Bank and the European Parliament (the existence of five presidents is testimony to the bureaucratic skills of the elite) published a report arguing for fiscal union in which “decisions will increasingly need to be made collectively,” and implicitly supporting the idea of a single finance minister for the euro area. This approach of creeping transfer of sovereignty to an unelected center is deeply flawed and will meet popular resistance. As Otmar Issing, the first chief economist of the European Central Bank and the intellectual force behind the ECB in its early years, argued:

Political union … cannot be achieved through the back door, by eroding members’ fiscal-policy sovereignty. Attempting to compel transfer payments would generate moral hazard on the part of the recipients and resistance from the donors.

In pursuit of peace, the elites in Europe, the United States and international organizations such as the IMF have, by pushing bailouts and a move to a transfer union as the solution to crises, simply sowed the seeds of divisions in Europe and created support for what were previously seen as extreme political parties and candidates. It will lead to not only an economic but a political crisis.
In 2012, when concern about sovereign debt in several periphery countries was at its height, it would have been possible to divide the euro area into two divisions, some members being temporarily relegated to a second division with the clear expectation that after a period – perhaps 10 or 15 years – of real convergence, those members would be promoted back to the first division.

It may be too late for that now. The underlying differences among countries and the political costs of accepting defeat have become too great. That is unfortunate both for the countries concerned – because sometimes premature promotion can be a misfortune and relegation the opportunity for a new start – and for the world as a whole because the euro area today is a drag on world growth.

Germany faces a terrible choice. Should it support the weaker brethren in the euro area at great and unending cost to its taxpayers, or should it call a halt to the project of monetary union across the whole of Europe?

The attempt to find a middle course is not working. One day German voters may rebel against the losses imposed on them by the need to support their weaker brethren, and undoubtedly the easiest way to divide the euro area would be for Germany itself to exit. But the more likely cause of a breakup of the euro area is that voters in the south will tire of the grinding and relentless burden of mass unemployment and the emigration of talented young people.

The counter-argument – that exit from the euro area would lead to chaos, falls in living standards and continuing uncertainty about the survival of the currency union – has real weight. But if the alternative is crushing austerity, continuing mass unemployment, and no end in sight to the burden of debt, then leaving the euro area may be the only way to plot a route back to economic growth and full employment. The long-term benefits outweigh the short-term costs. Outsiders cannot make that choice, but they can encourage Germany, and the rest of the euro area, to face up to it.

If the members of the euro decide to hang together, the burden of servicing external debts may become too great to remain consistent with political stability. As John Maynard
Keynes wrote in 1922:

It is foolish … to suppose that any means exist by which one modern nation can exact from another an annual tribute continuing over many years.

It would be desirable, therefore, to create a mechanism by which international sovereign debts could be restructured within a framework supported by the expertise and neutrality of the IMF, so avoiding, at least in part, the animosity and humiliation that accompanied the latest agreement on debt between Greece and the rest of the euro area in 2015. It was, I regret to say, an Englishman, First Lord of the Admiralty Sir Eric Campbell-Geddes, who set the tone for the harsh treatment of debtors when he said in a speech before the Versailles Peace Conference that “we shall squeeze the German lemon until the pips squeak!”

As early as 2003, the IMF debated the creation of a “sovereign debt restructuring mechanism.” The idea was to ensure a timely resolution of debt problems to help both debtors and creditors, and to recognize the prisoner’s dilemma in which an individual creditor had an incentive to hold out for full repayment, even though, collectively, creditors would be better off by negotiating with the debtor. Progress on the creation of such a mechanism was defeated by opposition from the United States, which favored bailouts over defaults, and Germany, which did not want to encourage the belief that sovereigns might be allowed to default.

Neither objection made sense. By failing to impose losses on the private-sector creditors of periphery countries in the euro area in 2012, the IMF and the European institutions took on obligations on which they were subsequently forced to accept losses. It is all too easy to pretend that throwing yet more money at a highly indebted country will solve the immediate crisis. It is only too likely that a sovereign debt restructuring mechanism will be needed in the foreseeable future. Without one, an ad hoc international debt conference to sort out the external sovereign debts that have built up may be needed.

But debt forgiveness, inevitable though it may be, is not a sufficient answer to all our problems. In the short run, it could even have the perverse effect of slowing growth. Sover-
The Milken Institute Review

Foreign borrowers have already had their repayment periods extended, easing the pressure on their finances. There would be little change in their immediate position following explicit debt forgiveness. Creditors, by contrast, may be under a misapprehension that they will be repaid in full, and when reality dawns they could reduce their spending. The underlying challenge is to move to a new equilibrium in which new debts are no longer being created on the same scale as before.

**ESCAPING THE PRISONER’S DILEMMA**

A major impediment to the resolution of the disequilibrium facing so many economies is the prisoner’s dilemma they face – if they and they alone take action, they could be worse off. The problem now is how to reconcile the prisoner’s dilemma with people’s overwhelming desire to control their own destiny. The prisoner’s dilemma prevented countries from rebalancing their economies. A coordinated move to a new equilibrium would be the best outcome for all.

By this I do not mean attempts to coordinate monetary and fiscal policy. Such efforts have a poor track record, ranging from the policies of the Federal Reserve in the 1920s, which held down interest rates in order to help other countries rejoin the gold standard, so creating a boom that led to the stock market crash in 1929 and the Great Depression, to the attempts in the mid-1980s to stabilize exchange rates among the major economies, which led to the stock market crash in 1987. Moreover, monetary and fiscal policies are not the route to a new equilibrium.

Many countries can now see that they have taken monetary policy as far as it can go. The weakness of demand across the world means that many, if not most, countries can credibly say that if only the rest of the world were growing normally then they would be in reasonable shape. But since it isn’t, they aren’t. So with interest rates close to zero, and fiscal policy constrained by high government debt, the objective of economic policy in a growing number of countries is to lower the exchange rate.

In countries as far apart as New Zealand, Australia, Japan, France and Italy, central banks and governments are becoming more and more strident in their determination to talk the exchange rate down. Competitive depreciation is a zero-sum game as countries try to “steal” demand from each other. In the 1930s, the abandonment of the gold standard, and hence of fixed exchange rates between countries, allowed central banks across the globe to adopt easier monetary policies. Although the benefits of the reduction in exchange rates cancelled each other out, the easier monetary policies helped to bring about a recovery from the Great Depression. Today, however, monetary policy is already about as loose as it could be. There is a real risk of an implicit or explicit “currency war.”

These questions are symptomatic of a wider problem in the world economy – a problem that Dani Rodrik of Harvard University has christened the “political trilemma of the global economy.” It is the mutual incompatibility of democracy, national sovereignty and economic integration. Which one do we surrender?

If national sovereignty is eroded without clear public support, democracy will come
under strain – as we are seeing in Europe, where democracy and national sovereignty are closely intertwined. Political union, in the sense of a genuinely federal Europe, has stalled. To reconcile democracy and monetary union would require clearly defined procedures for exit from monetary union. There are none.

The degree of political integration necessary for survival of monetary union is vastly greater than, and wholly different from, the political cooperation necessary to create a path toward a sustainable economic recovery in Europe. Even if the former could be imposed by the central authorities on countries in the euro area – and there are few signs that this would be a popular development – to extend the same degree of integration to countries outside the euro area would surely shatter the wider union. For the foreseeable future, the European Union will comprise two categories of member: those in and those not in the euro area. Arrangements for the evolution of the European Union need to reflect that fact.

Such issues are a microcosm of broader challenges to the global order. The Asian financial crisis of the 1990s, when Thailand, South Korea and Indonesia borrowed tens of billions of dollars from Western countries through the IMF to support their banks and currencies, showed how difficult it is to cope with sudden capital reversals resulting from a change in sentiment about the degree of currency or maturity mismatch in a nation’s balance sheet, and especially in that of its banking system.

The IMF cannot easily act as a lender of last resort because it does not own or manage a currency. In the Asian crisis, therefore, it was almost inevitable that conditionality was set by the United States because the need of those countries was for dollars. The result was the adoption by a number of Asian countries of do-it-yourself lender-of-last-resort policies, which involved their building up huge reserves of U.S. dollars out of large trade surpluses. That, together with their export-led growth strategy, led directly to the fall in real interest rates across the globe after the fall of the Berlin Wall.

Resentment toward the conditions imposed by the IMF (or the U.S.) in return for financial support has also led to the creation of new institutions in Asia, ranging from the Chiang Mai Initiative, a network of bilateral swap arrangements between China, Japan, Korea and the ASEAN countries to serve as a regional safety net mechanism now amounting to $240 billion, to the new Chinese-led Asian Infrastructure Investment Bank that was created in 2015. It is likely that Asia will develop its own informal arrangements that will, in essence, create an Asian IMF, an idea that was floated in 1997 at the IMF Annual Meetings in Hong Kong and killed off by the United States. Twenty years on, the power of the U.S. to prevent a mutual insurance arrangement among Asian countries is limited.

The governance of the global monetary order is in danger of fragmentation. In the evolving multipolar world, there are few remnants of the idealism of Bretton Woods. The combination of free trade and American power was a stabilizing force. As the financier and historian James MacDonald puts it in his book *When Globalization Fails*:

> The unspoken bargain was that the United States would exercise a near monopoly of military force. However, it would use its force not to gain exclusive economic advantages, but as an impartial protector of Western interests. Under the American umbrella, the non-Communist world flourished.
The world of Bretton Woods passed away a long while ago, and with it the effectiveness of the post-war institutions that defined it – the International Monetary Fund, the World Bank and the Organization for Economic Cooperation and Development (OECD). The veto power of the United States in the IMF, and the distribution of voting rights more generally, undermines the legitimacy of the Bretton Woods institutions in a world where economic and political power is moving in new directions.

It is not easy for any multilateral institution to adapt to major changes in the assumptions that underlay its creation. The continuing refusal of the U.S. Congress to agree to relatively minor changes to the governance of the IMF threatens to condemn the latter to a declining role. The stance of the IMF in the Asian crisis, its role as part of the so-called troika in the European crisis, and its reputation in Latin America mean that it is in danger of becoming ineffective. A key role of the IMF is to speak truth to power, not the other way round as it came close to doing in Asia in the 1990s and in Europe more recently.

The United States is still the largest player in the world economy, and the dollar the dominant currency. But little else has remained the same. In Asia and in Europe, new players have emerged. China is now, with output measured in comparable prices, the largest economy in the world, returning to the position it occupied by virtue of its population size in the 19th century. China and the United States will have an uneasy coexistence as the two major powers in Asia and, until a new, more-equal relationship emerges, uncertainty about the most vibrant region of the world will cast a shadow over economic prospects for the continent. A multi-polar world is inherently more unstable than the post-war stability provided by the umbrella of the Pax Americana.

Misguided attempts to suppress national sovereignty in the management of an integrated world economy will threaten democracy and the legitimacy of the world order. Yet, acting alone, countries may not be able to
achieve a desirable return to full employment. There are too many countries in the world today for an attempt to renew the visionary ideals of the Bretton Woods conference to be feasible. For a short time in 2008-09 countries did work together, culminating in the G20 summit in London in the spring of 2009. But since then, leadership from major countries, the international financial institutions and bodies such as the G7 and G20 has been sorely lacking. They provide more employment for security staff and journalists than they add value to our understanding of the world economy, as a glance at their regular communiqués reveals. Talking shop can be useful, but only if the talk is good.

As time goes by, parallels between the interwar period and the present become disturbingly more apparent. The decade before 2007, when the financial crisis began, seems in retrospect to have more in common with the 1920s than we realized. Both were periods when growth was satisfactory, but not exceptional, when the financial sector expanded, and when commentators were beginning to talk about “a new paradigm.” After 2008, the parallels with the 1930s also began to grow. The collapse of the gold standard mirrors more recent problems with fixed exchange rates. The attempt to keep the euro together produced austerity on a scale not seen since the Great Depression, and led to the rise of extreme political parties across Europe.

A prisoner’s dilemma is still holding back the speed of recovery. A sensible coping strategy to deal with this problem is not to artificially coordinate policies that naturally belong to national governments, but to seek agreement on an orderly recovery and rebalancing of the global economy. The way in which each country will choose to rebalance is a matter for itself, but it is in the interests of all countries to find a common timetable for that rebalancing. The natural broker for an agreement is the IMF.

Our best chance of solving the prisoner’s dilemma while retaining national sovereignty is to use the price mechanism, not suppress it.
Arrangements to fix or limit movements of exchange rates tend to backfire as unexpected events require changes in rates to avoid economic suffering. At the heart of the problem is the question that so troubled the negotiators at Bretton Woods. How can one create symmetric obligations on countries with trade surpluses and trade deficits?

The international monetary order set up after World War II failed to do so, and the result is that fixed exchange rates have proved deflationary. For a long time the conventional wisdom among central banks has been that if each country pursues a stable domestic monetary and fiscal policy then they will come close to achieving a cooperative outcome. There is certainly much truth in this view. But when the world becomes stuck in a disequilibrium, the prisoner’s dilemma bites. Cooperation then becomes essential.

Placing obligations on surplus countries has not and will not work. There is no credible means of enforcing any such obligations. Enlightened self-interest to find a way back to the path of strong growth is the only hope. The aim should be fourfold:

• to reinvigorate the IMF and reinforce its legitimacy by reforms to its voting system, including an end to a veto by any one country;
• to put in place a permanent system of swap agreements among central banks, under which they can quickly lend to each other in whichever currencies are needed to meet short-term shortages of liquidity;
• to accept floating exchange rates;
• to agree on a timetable for rebalancing of major economies, and a return to normal real interest rates, with the IMF as the custodian of the process.

The leadership of the IMF must raise its game. The two main threats to the world economy today are the continuing disequilibrium between spending and saving, both within and between major economies, and a return to a multipolar world with similarities to the unstable position before World War I. Whether the next crisis will be another collapse of our economic and financial system, or whether it will take the form of political or even military conflict, is impossible to say. Neither is inevitable. But only a new world order could prevent such an outcome. We must hope that the pressure of events will drive statesmen, even those of “inconceivable stupidity,” to act.

THE AUDACITY OF PESSIONISM

The experience of stubbornly weak growth around the world since the crisis has led to a new pessimism about the ability of market economies today to generate prosperity. One increasingly common view is that the long-term potential rate of economic growth has fallen.

In the United States, there is no shortage of plausible explanations for such a change—the marked fall since the crisis in the proportion of the population who are available to work, slower growth of the population itself and heavier regulatory burdens on employers. It is important not to be carried away by changes over short periods of time. The U.S. Bureau of Labor Statistics (BLS) estimates the contribution to growth of increases in labor supply (hours worked), the amount of capital with which people work, and the efficiency of the labor and capital employed.

Ultimately, the benefits of economic growth stem from this last factor, which reflects scientific and technical progress—“multifactor productivity,” in the phrase of the BLS statisticians. From the mid-1980s until the onset of the crisis in 2007, multifactor productivity rose at about 1 percent a year. Between 2007 and 2014, it rose by 0.5 percent a year. As a result, the annual rate of growth
of output per hour worked — reflecting both technical progress and the amount of capital with which each person works — fell from just over 2 percent between the mid-1980s and 2007 to around 1.5 percent between 2007 and 2014. If that reduction persisted it would affect living standards in the long run. But growth rates of productivity are quite volatile over short periods of time and it is far from clear that they represent a significant change to the future potential of the economy.

Is there good cause for pessimism about the rate at which economies can grow in future? There are three reasons for caution about adopting this new-found pessimism. First, the proposition that the era of great discoveries has come to an end because the major inventions, such as electricity and airplanes, have been made and humankind has plucked the low-hanging fruit is not convincing. In areas such as information technology and biological research on genetics and stem cells we are living in a golden age of scientific discovery. By definition, ideas that provide breakthroughs are impossible to predict, so it is too easy to fall into the trap of thinking that the future will generate fewer innovations than those we saw emerge in the past.

When Alvin Hansen proposed the idea of “secular stagnation” in the 1930s, he fell into just this trap. In fact, the 1930s witnessed significant innovation, which was obscured by the dramatic macroeconomic consequences of the Great Depression. Alexander Field, an American economist, has documented large technological improvements in industries such as chemicals, transport and power generation. By 1950, real GDP in the U.S. had regained its pre-Depression trend path, and rose by 90 percent in a decade after the end of the Great Depression.

Second, although the recovery from the downturn of 2008-09 has been unusually slow in most countries, the factors contributing to the growth of labor supply have behaved quite differently across countries. For example, in contrast to the U.S., the U.K. has experienced buoyant population growth and rising participation in the labor force. And even some of the periphery countries in the euro area, such as Spain, have recently seen rises in measured average productivity growth. The factors determining long-term growth seem to be more varied across countries than the shared experience of a slow recovery since the crisis, suggesting that the cause of the latter is rooted in macroeconomic behavior rather than a deterioration in the pace of innovation.

Third, economists have a poor track record in predicting demographic changes. Books on the theme of the economic consequences of a declining population were common in the 1930s. A decade and a world war later, there was a baby boom. Agnosticism about future potential growth is a reasonable position; pessimism is not. History suggests that changes to underlying productivity growth occur only slowly. Many economists in the past have mistakenly called jumps in trend growth on the basis of short-term movements that proved short-lived.

The two main threats to the world economy today are the continuing disequilibrium between spending and saving, and a return to a multipolar world with similarities to the unstable position before World War I.
The case for pessimism concerns prospective demand growth. In the wake of a powerful shock to confidence, monetary and fiscal stimulus in 2008 and 2009 was the right answer. But it exhibits diminishing returns. In recent years, extraordinary monetary stimulus has brought forward consumption from the future, digging a hole in future demand. With a prospect of weak demand in the future, the expected return on investment becomes depressed. Even with unprecedentedly low interest rates and the printing of money, it can boost demand in the short run, but its effects fade as the paradox of policy kicks in. Only a move to a new equilibrium consistent with the revised narrative will end stagnation. Low growth in the global economy reflects less a lack of “animal spirits” and more the inability of the market, constrained by governments, to move to a new set of real interest rates and real exchange rates in order to find a new equilibrium.

The challenge we now face is plotting a route to a new equilibrium. The paradox of

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becomes harder and harder to stimulate domestic consumption and investment.

What began as an imbalance between countries has over time become a major internal disequilibrium between saving and spending within economies. Spending is weak today, not because of irrational caution on the part of households and businesses following the shock of the crisis, but because of a rational narrative that in countries like the U.S. and U.K., consumer spending was unsustainably high before the crisis and must now follow a path below the pre-crisis trend. In countries like China and Germany, exports were unsustainably high, and they, too, are now experiencing weak growth as demand in overseas markets slows. Those countries have not been able to move to a new equilibrium either individually or collectively, and until they do, recovery will be held back.

In circumstances characterized by a paradox of policy – in which short-term stimulus to spending takes us further away from the long-term equilibrium – Keynesian stimulus policy applies to all countries, both those that previously consumed and borrowed too much, and those that spent too little. Short-term stimulus reinforces the misallocation of investment between sectors of the economy, and its impact on spending peters out when households and businesses come to realize that the pattern of spending is unsustainable. China and Germany need investment to produce goods and services to meet domestic consumer demand rather than to support the export sector. The opposite is the case in the United States, United Kingdom and parts of Europe.

Most discussion of this demand pessimism fall into one of two camps. On the one hand, there are those who argue that our economies are facing unusually strong but temporary “headwinds” that will die down in due course, allowing central banks to raise interest rates to more normal levels without undermining growth. We simply need to be patient, and a natural recovery will then follow.

This view is in my judgment an incomplete and misleading interpretation of the factors
that have produced persistently weak growth. A change in the narrative used by households to judge future incomes is not a “headwind” that will gradually abate, but a permanent change in the desired level of spending. We cannot expect the United States to continue as the “consumer of last resort” and China to maintain its growth rate by investing in unprofitable construction projects. Central banks, like the cyclist climbing an ever-steeper hill, will become exhausted. And if recovery does not come, they will be seen to have failed, eroding the support for the independence of central banks that was vital to the earlier achievement in conquering inflation.

On the other hand, there are those who advocate even more monetary and fiscal stimulus to trigger a recovery. To be sure, it is hard to argue against a well-designed program of public infrastructure spending financed by government borrowing, especially when you are traveling through New York’s airports. But the difficulty of quickly organizing a coherent plan for expanding public investment while maintaining confidence in long-term fiscal sustainability makes this option one for the future rather than today, albeit one worthy of careful preparation.

Further monetary stimulus, however, is likely to achieve little more than taking us further down the dead-end road of the paradox of policy. More extreme versions of monetary and fiscal expansion include proposals for an increase in government spending that would be financed by printing money, and “helicopter drops” of money into the pockets of all citizens. Radical though they sound, neither is in fact different in essence from the policies that have so far failed to generate a return to pre-crisis paths of output. Financing more government spending by printing money is equivalent, in economic terms, to a combination of (a) additional government spending financed by issuing more government debt and (b) the creation of money by the central bank to buy government debt (the process known as quantitative easing). Equally, helicopter drops of money are equivalent to a combination of debt-financed tax cuts and quantitative easing – the only difference being that the size of spending or tax cuts is decided by government and the amount of money created is decided by the central bank.

Since both elements of the combination have been tried on a large scale and have run into diminishing returns, it is hard to see how even more of both, producing a short-run boost to demand that will soon peter out, will resolve the paradox of policy. Dealing with the underlying disequilibrium is paramount.

The narrative revision downturn, triggered by the crisis, has left a hole in total spending. Central banks have, largely successfully, filled that hole by cutting interest rates and printing electronic money to encourage households and businesses to bring forward spending from the future. But because the underlying disequilibrium pattern of demand has not been corrected, it is rational to be pessimistic about future demand.

That is a significant deterrent to investment today, reinforced by uncertainty about the composition of future spending. Since traditional macroeconomic policies will not lead
us to a new equilibrium, and there are no easy alternatives, policymakers have little choice but to be audacious. What should they do to escape the trap of rational pessimism? In broad terms, the aim must be twofold – to boost expected incomes through a bold program to raise future productivity, and to encourage relative prices, especially exchange rates, to move in a direction that will support a more sustainable pattern of demand and production. Those aims are easy to state and hard to achieve, but there is little alternative, other than waiting for a crash in asset values and the resulting defaults to reset the economy.

but to be audacious.

With the audacity of pessimism, we can do better. A reform program might comprise three elements.

First, the implementation of measures to boost productivity. Since the crisis, productivity growth has been barely noticeable, and well below pre-crisis rates. A major reason for this disappointing performance is that there has been a sharp fall in the growth rate, and perhaps even in the level, of the effective capital stock in the economy.

Part of this reflects the fact that past investment was in some cases a mistake, directed to sectors in which there was little prospect of future growth, and is now much less productive than had been hoped. Some of the capital stock is worth less than is estimated in either company accounts or official statistics, or even in economists’ models.

Another part reflects pessimism about future demand and uncertainty about its composition, which has led to a fall in business investment around the world. Current demand is being met by expanding employment. Companies do not wish to repeat the mistake of investing in capital for which there is little future profitable use. If future demand turns out to be weak then it will be cheaper to adjust production by laying off employees.

A higher ratio of labor to effective capital explains weaker productivity growth. Reforms to improve the efficiency of the economy, and so the rate of return on new investment, would stimulate investment and allow real interest rates to return to a level consistent with a new equilibrium. Over time, as investment rebuilt the effective capital stock, productivity growth would return to rates reflecting the underlying innovation in a dynamic capitalist economy.

Reforms to boost productivity are not a “get out of jail free” card – they are easier to conceive than implement, and hit political obstacles from potential losers who express their concerns more vocally than the potential winners. But the only alternative to large and costly shifts in relative prices is changing the narrative about expected future incomes. And there certainly exist opportunities to boost productivity:

- in the product market to reduce monopolies and increase competition;
- in the tax system to reduce distortions between saving and spending, eliminate complex deductions and lower marginal tax rates;
- in the public sector to reduce the cost of providing public services;
- in the field of regulation to lower the burden imposed on the private sector;
- more generally, to improve public infrastructure to support the rest of the economy.

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