

Buying time to revive growth

Debt forgiveness may be the interim solution for the world's economic malaise

BY STEVE BRICE

THERE is a growing perception that monetary policy is losing its power to solve the world's economic problems. This may be misleading. What is probably true is that incremental policy easing is experiencing diminishing – and possibly negative – returns. Therefore, central banks – and governments – may need to get even more unconventional to reverse the tide. Japan appears to be closest to the tipping point in this regard, although there are few signs that it is winning the battle.

As the global economy faltered while recuperating from its longest recession since the Great Depression, central banks in the developed world moved from simply lowering interest rates – bringing them all the way down to zero – to issuing forward guidance with promises to keep interest rates low for a long period... to buying bonds, ultimately reducing rates to negative. The euro area, Japan and some Scandinavian countries are notable examples.

The problem is the lack of sufficient growth and demand. Although the developed economies have recovered somewhat from the Great Recession, they are still not growing at their pre-crisis pace. This is not surprising given economic growth in the 40 years prior to the 2008-09 financial crisis was largely financed by debt. The emerging economies bucked this trend for a while, helped by the seemingly unending rise of China. However, in the aftermath of the financial crisis, China's boom also became increasingly debt-financed, with the result that attempts to deleverage have led to much slower growth in China and other emerging markets.

We are all taught as kids that we cannot forever spend beyond our means and that the chickens will ultimately come home to roost; so it is with countries and economies. With global debt levels very high and rising, the world is likely to experience continued sluggish growth, at best, for years to come.

So how do we deal with this? In theory, there are several ways in which one can reduce debt financing concerns.

- i) Cut funding costs
- ii) Pay off debts
- iii) Grow our way out of the debt
- iv) Write the debt off

There are problems with all four options. Let's take the first one – interest rates are already extremely low and it is difficult to cut funding costs much further.

In the second option, if everybody tries to pay off debt it would reduce spending and investment, undermining demand, corporate revenue and economic growth. This can lead to a negative spiral, espe-

cially if it incurs deflation (or falling prices) which increases the debt burden of borrowers in inflation-adjusted terms.

The third route – through faster growth – is clearly the optimal outcome. Here, it is nominal growth that matters (real growth plus inflation). However, the high debt levels make this outcome difficult to achieve. As stated, despite extraordinarily strong monetary responses, global growth has been sluggish and inflation benign. It is possible this may change, especially if governments become less frugal, but it is by no means a slam dunk that any fiscal policy stimulus will be sufficient to create growth and/or inflation. In fact, such a route may burden the economy with more debt, bringing the problems back to square one.

Monetary policy easing

Against this backdrop, the potential for incremental monetary policy easing to accelerate growth – through more bond purchases or cutting interest rates deeper into negative – does not look great. Indeed, the theory that negative interest rates spur higher saving, instead of spending – as people prepare for retirement – is gaining more advocates (although I am not sure raising interest rates will encourage them to spend, either).

This leaves us with the last option – that of debt write-offs. Historically, this has been done by governments defaulting on their debt obligations. Argentina and Greece have been serial defaulters (Argentina, ironically, successfully tapped international bond markets in April for the first time since its 2001 default) and the pain that this causes to the economies is clear for all to see.

One idea that is getting some airtime, but is not yet being taken seriously, is that of debt forgiveness, rather than default. This may sound crazy: Who in their right mind would lend somebody money and then say that there is no need to pay them back? But if we think about who owns this debt, then the idea becomes less fanciful. Years of quantitative easing by the developed economies have resulted in a lot of government debt being owned by central banks with theoretically unlimited access to money (through their control of the printing presses). What is to stop a central bank from writing off the debt that it is owed?

In practice, there are significant constraints: It is likely to be politically unpalatable and there may be genuine fears that doing so could spark uncontrollable inflation – direct monetary financing of government deficits rarely ends well (ask anybody in Zimbabwe or read the history of the Weimar Republic in pre-World War II Germany).

But one has to believe there is a potential tipping point at which the downside risks of such action (hyperinflation, or at least much higher inflation) is less than the downside risks of inaction – that is, a depression. After all, central bankers have better tools to tamp down inflation than to fight deflation.

Are we there yet? Clearly not. No central bank is seriously considering such action. Japan is probably closest – its economy and inflation are faltering and the Japanese yen is rallying despite massive amounts of monetary stimulus. Would more bond (and equity) purchases or more deeply negative interest rates really help? I doubt it. But if the Bank of Japan were to write off significant chunks of government debt, it would eradicate the need for fiscal consolidation and take the brakes off the economy.

Of course, longer term, other constraints would have to be dealt with as well. Economic reforms, both in the developed and the emerging world – which would ultimately boost productivity, reduce inequality and raise overall global demand for goods and services – are the real answer to the world's problems. But reforms take time to deliver. Meanwhile, a debt write-off may buy significant time for the authorities to implement innovative measures to increase supply-side efficiency and revive global growth. ▣

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