Another Intractable Problem: Economic Growth, Sovereign Solvency, Inflation and Equality

In early 2012 it gradually became apparent that the world was slipping into a synchronized slowdown. At least it became gradually apparent to slower minds like this one. By mid 2012 it became quite clear that the US recovery which started in August or September 2011 was petering out, Europe had never really picked up since the Summer of 2011 when Greece first exposed the vulnerability of the Union, and China's slide was gaining momentum. In the last month we have seen better numbers from China, continuing weakness in Europe and in the US, a rebound in the real estate market if nowhere else in that economy.

What are governments hoping for and working to? The scale of the debt problems whether in the West or in Asia are too much not to enlist the aid of time. Some call this kicking the can down the road. Its not a good strategy, on its own, but its not a bad strategy if it buys sufficient breathing space to address more fundamental problems. The problem in Western democracies is that the gestation of such policies extends beyond the election cycle.

Lets make a to do list for a garden variety sovereign in a bit of a tight spot.

1. Increase real GDP growth. This is hard to do. Increase nominal GDP growth. This is also not easy without fiscal intervention which is constrained by budgetary issues. Keeping a low but positive real or nominal GDP growth seems to be the easiest best that one can do.
2. Reduce unemployment. This depends on the success of 1 above.
3. Keep inflation high as long as it does not surface in official statistics or lead to social unrest. This should debase debt without damaging officially measured real GDP growth.
4. Keep the banking system functioning. Only Europe has a real problem on this point. The US has recapitalized its banks and Asia looks healthy for now.

The opacity and complexity of banks' financials mean that this problem never ever truly goes away. Vigilance is required at all times.

5. Keep interest rates low. Facilitate the refinancing of the government and other credit strapped institutions. QE suffices for now in achieving this aim. Ideally there will be sufficient demand for government debt that debt monetization can stop. Low interest rates are necessary for an over-indebted world. If interest rates rise the implications for large swathes of the economy are highly negative.
6. Keep a competitively low exchange rate. The world's economies cannot all simultaneously operate this strategy successfully. Yet attractive terms of trade are necessary to keep the export sector supported. In a sufficiently globalized world excessive success of one country can likely lead to instability for its trading partners making any such success short lived. Low FX volatility is good for all.
7. Balance the budget. This is almost intractable but it needs to be addressed at some point. By addressing refinancing risk in 5 above, central banks have bought time for governments to at least turn the budgets in the right direction. The longer term goal of balancing the budget is of course to reduce the outstanding amount of government debt and improve.

The above is a realistic, practical and feasible strategy to pursue, subject to a few limitations.

A. The time bought by debt monetization might not be well spent. There are many issues to address and the extra time obtained by debt monetization is finite. Many things can go wrong.

B. The scale of the problem might be bigger than everybody thought. This is a serious risk and one that can come from the banking system or sovereigns hiding the scale of their solvency issues.

C. Central banks are unable to reduce the banking system's balance sheets sufficiently quickly in the face of accelerating inflation or recovery. Point 3 above is a risky strategy as it assumes that a desired level of inflation can be sustained without accelerating beyond targets.

D. ~~Investors' patience runs out before the root causes of the sovereign crisis are adequately addressed. This can lead to higher interest rates even in the absence of inflation or recovery and can threaten the cash flow solvency of~~

~~sovereigns. Companies' cost of debt would likewise rise. Given the current low levels of interest rates, the immediate impact on debt service could be severe. The stock market may also give up which would damage sentiment and cause a recession or depression.~~

E. Debt monetization and fiscal reflation are redistributive policies. The proposed redistributions may prove unpopular and precipitate a reaction.

The strategy is not entirely without merit and not completely hopeless, but there are serious risks, some of which have been understated above.