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July 15, 2011

HOPING RATIONALITY AND LEADERSHIP WIN OUT OVER POLITICS

The two-year anniversary of the global economic recovery has arrived, but you won't find many people celebrating the event. This reflects the fact that we are not truly out of the crisis. Indeed, it appears that the last act of this Shakespearean tragedy has four scenes, and we're only in scene three.

The opening three acts that covered much of the 2000s were characterized by excess, with Shakespearean flaws of greed and hubris front and centre. Act one was housing bubbles through much of the advanced world. Act two was the fundamental mispricing of risk throughout the financial system. Act three was the denial by governments, financial markets and individuals that the party could continue indefinitely. This set the stage for the painful fourth act, with its four scenes.

The first scene was the financial crisis in 2008 when financial markets started to unwind the massive mispricing of real estate in many countries. This, in turn, fueled a repricing of risk more broadly across most asset classes and led to an enormous contraction in financial flows (i.e. the liquidity crunch) that threatened to seize up the global financial system. A powerful and coordinated policy response followed. Central banks around the world took unprecedented action, slashing interest rates and injecting vast sums of money in order to permit the financial system time to wrap its head around the new financial environment in early 2009.

The financial crisis and asset price adjustment led to act four, scene two, which was the economic crisis as characterized by economic contractions and rapidly rising unemployment. Given the structure of modern economies, the second scene occurred quickly after the first scene. The inherent dilemma was that unwinding the global imbalances in a short period of time would lead to economic outcomes that were simply unacceptable to policy makers. As a consequence, enormous fiscal stimulus was injected and unheard of new policy measures were taken to limit the economic downturn and to help support renewed growth. Ultimately, the easing of monetary and fiscal policy achieved the desired goal of restarting economic growth by mid-2009, but it did not end the crisis.

The policy actions transformed one set of imbalances into another set of imbalances, setting the stage for the current scene three – the political crisis. For countries that were running substantial fiscal deficits or had unacceptably large unfunded liabilities, the fiscal response to the financial and economic crises was too costly. It also revealed the fact that many governments had made commitments to their people over past decades that were simply unaffordable. In some countries, policymakers failed in their attempt to insulate their citizens adequately to the deterioration in economic conditions. The resulting crisis has taken three forms: fears of outright government insolvency (such as in Greece, Ireland and Portugal), worries about the ability of governments to develop a credible fiscal plan for the future (such as in the United States), or a loss of confidence in the ability of governments to provide a rising standard of living for their people in the future (i.e. the rioting in various nations embarking on fiscal austerity, the Arab Spring, the emergence of the Tea Party). This third scene could be called the political crisis, the sovereign debt crisis or the fiscal crisis – take your pick. I prefer the political crisis, since it captures political friction on many fronts: between governments (i.e. Germany versus Greece); between political parties (i.e. Republicans versus Democrats); within political parties (i.e. Republicans versus Tea Party); and between people versus government (i.e. the Arab Spring).

Given that we are in the midst of scene three, there is considerable uncertainty as to how the play will end. The Bard is keeping us guessing. Most economists generally favor what can be called the 'economic rational' outcome. This scenario is one where governments once again avoid unacceptable outcomes, regardless of how distasteful the policy requirements may be to their ideology.

In Europe, this would take the form of a managed debt default in Greece, and perhaps Ireland and Portugal. It would ultimately require significant further fiscal transfers from the core euro countries (with IMF support) to the insolvent peripheral countries, greater fiscal union across the euro-zone, and something in the order of a 50 percent hair cut on the value of insolvent government bonds.

In the United States, the rational outcome would be acceptance that a mix of higher taxes and spending cuts is necessary, but the vast bulk of the mix could be towards the latter (say roughly an 15:85 per cent split). Future entitlement spending would also have to be tackled to achieve a sustainable long-term fiscal outcome. In the immediate future, the debt ceiling must be lifted. The outcome of not doing so is unacceptable. A credit rating downgrade for America that is the holder of the world reserve currency would lead to sharply higher U.S. interest rates for all borrowers, a considerably lower U.S. dollar, not to mention the potential failure in making the required payments to citizens or a shutdown of government services. The public outrage from such a result would be so strong that a political compromise would likely come quickly, but the damage to the perceived credit worthiness of the nation would linger. Financial markets would conclude that America cannot deal with the more substantive issue of coming up with a long-term credible fiscal plan to address deficits and the looming debt problem.

However, there is no guarantee that the rational outcome will occur. Politics can, and often does, trump economics. Given how fragile the global economy is at the moment, it would not take much to create a renewed period of financial strain and economic contraction. This is not the most likely outcome, but the possibility cannot be dismissed.

As the third crisis plays out, it leads to the final scene. The true Shakespearean tragedy is if politics wins out and the economic recovery stalls or reverses course. Worse still would be if the political crisis feeds back into a renewed financial crisis. However, if economic rationality wins out and the tough political decisions are taken, we enter a long denouement, which could take the better part of the next decade.

This scenario is where the true global rebalancing is completed. The deleveraging of the world's advanced economies is resolved within household or government finances. For example, the U.S. economy will not be on sound footing until it has fully addressed its foreclosure problem, which is depressing home prices and impairing the financial system. Then America must come to terms with high structural unemployment. Furthermore, the fiscal rebalancing in the U.S. and Europe must run its course.

Obviously, this outcome would not play out smoothly. Many political, economic, and financial challenges would have to be overcome. Regrettably, this best-case scenario augurs for sub-par real economic growth in the advanced world and continued extremely low interest rates over the next several years. In the late stage of the rebalancing, higher inflation will likely materialize, reflecting the hyper-stimulative monetary policy environment, which would help to reduce debt burdens and lower real exchange rates, thus helping to facilitate the rebalancing of global trade.

Elsewhere in the world, the global rebalancing will take the form of continued strong economic growth in emerging markets. Many of these countries are tackling an inflation problem at the moment, which may temporarily slow their expansions. But, the emerging markets will continue to rapidly advance their share of the world economy. Moreover, their fast economic development will support increased domestic demand, which will be partially facilitated by the strengthening or creation of social safety nets.

As this plays out, the current account deficits in the advanced world, such as the United States, will diminish, corresponding with increased national savings rates. The current account surpluses in the emerging world will diminish, corresponding to decreased national savings rates. It will also lead to foreign exchange adjustments to higher real exchange rates for the major emerging market nations.

To sum up, the last three years have felt like the last act of a Shakespearean tragedy, and this has corresponded to three scenes and three crises. We've been through the financial crisis and economic crisis. We're in the political crisis. The fourth and final scene can take various forms. To simplify to two scenarios: If emotion and politics dominates, financial stability and the economic recovery is in jeopardy, and an ugly fourth scene will ensue. If rationality wins out and tough policy decisions are made with leadership and resolve, the legacy of the financial crisis will be addressed, the unrealistic prior fiscal commitments will be unwound, and fiscal policy will be put on a long-term sustainable path, which ultimately unwinds the imbalances in the global economy.

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