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GLOBAL CENTRAL BANK FOCUS: FACTS ON THE GROUND

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Double-entry bookkeeping was a great invention. It is a shame that so many macroeconomists and political pundits—and, therefore, politicians themselves—seem to have forgotten it. One who hasn't is the *Financial Times*' Martin Wolf. And to the delight of all friends of the Levy Economics Institute, Martin cited in a recent column[1] the *financial balances approach* of the late Wynne Godley, who spent his last years as a Distinguished Scholar at Levy.

Godley's analytical framework should be the workhorse of discussions of global rebalancing, in the context of a deficiency of global aggregate demand. So, it was wonderful to see Martin riding Godley's horse. I'll walk you through it, but first the punch line: front-loaded fiscal austerity in countries with their own fiat currencies is unwarranted and is likely to have deleterious, deflationary effects on the global economy. How so?

Let's start with a simple tautology for any individual country:

Household Financial Balance +
Business Financial Balance +
Government Financial Balance +
Foreign Financial Balance = 0

Again, double-entry bookkeeping: the only way that one of the four sectors can run a deficit or surplus is for one or more of the other three sectors to run the opposite. This assertion doesn't,

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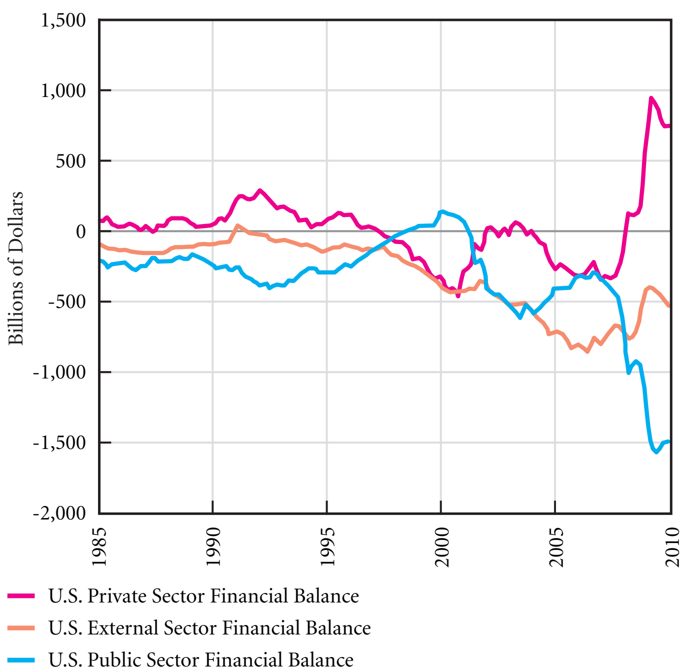
of course, tell us anything about causation. Nor does it tell us about the composition or the sustainability of the starting positions for global stocks of debt and assets. It's simply the tyranny of arithmetic for the flow of funds.

Right now, the household and business sectors in the developed world are running huge financial surpluses, in contrast to the opposite three years ago. In contrast, developed-country governments are running larger deficits. Meanwhile, the emerging world is running a still-large financial surplus with the developed world. Figure 1 tells the story for the United States:

Figure 1 U.S. Main Sector Balances, 1985–2010 (in billions of dollars, annualized quarterly)



Note: Summation may not foot to exact zero balance due to cyclical statistical discrepencies.

Source: Bureau of Economic Analysis, National Income and Product Accounts

Thus, any notion that fiscal austerity in the developed world will not be a cyclical drag on global aggregate demand growth, much less boost it, must rest on the presumption that (1) the household and business sectors in the developed world will reduce their surpluses and/or (2) that the emerging world will reduce its surpluses with the developed world.

Reverse-Ricardian Austerians

Why do so many implicitly make that presumption? With regard to reducing private sector surpluses in the developed world, it's called reverse-Ricardian equivalence. Recall, Ricardian equivalence is the notion that governmental deficits *cause* the private sector to increase its surpluses, so as to save for the future increase in taxes that inevitably will be required to reduce the government deficits. Thus, current evangelists of front-loaded fiscal austerity preach that if only governments would reduce their deficits, the private sector, freed from the fear of future tax increases, would spontaneously reduce their surpluses. Put differently, it is argued, if only governments would put their fiscal houses in order, the private sector would immaculately regain confidence in their own financial affairs, pull down their savings, and borrow more, boosting aggregate demand. Really, that is the argument, made with a straight face.

But it conveniently ignores *why* the private sector in the developed world is running a financial surplus: deflated asset prices, which have undermined the debt that had been applied to inflated asset prices. The private sector in the developed world wants to get its financial house in order! This is a profound structural change, running in parallel to a permanent downsizing of the shadow banking system and derisking of the conventional banking system. Simply put, both the demand and supply curves for private sector credit creation have shifted inward.

And the only way that can happen without increasing the risk of a deflationary depression is either for the developed-country governments to continue to run large financial deficits and/or for the emerging countries to reduce their financial surpluses. Again, the tyranny of arithmetic.

Thus, siren calls for front-loaded fiscal austerity in the developed world are de facto a bet that the emerging world is politically, financially, and culturally ready to dramatically reduce its financial surplus with the developed world, to shift dramatically away from a mercantilist-grounded growth model of exports to one based more on domestic demand, fueled by falling private sector savings rates. In the long run, such a structural change is obviously in the best interest of the emerging markets, letting their citizens enjoy the fruits of their own productivity rather than shipping those fruits to the developed world, taking back fiat currency paper in a vendor finance arrangement. And it is very likely to happen. But the time frame will not be a cyclical one, but a secular—if not supersecular—one.

Accordingly, it is most disheartening to hear born-again cyclical fiscal austerians[2] tout the notion that somehow there will not be a deflationary negative shock to global aggregate demand, if their course is followed. Paul Krugman gets even more worked up than Martin Wolf about this, or at least is more colorful in expressing his disdain in regular missives in the *New York Times* and in his blogs. But Martin is stepping up his game, declaring that the austerians' reverse-Ricardian cyclical path to salvation may be right, musing that "the moon may be made of green cheese, too."

And it is not surprising that both Paul and Martin are lifting the level of their Keynesian/Godley vitriol. Current fiscal deficits in fiat currency countries are not the cause of the Great Recession but the consequence of the Great Recession, which was the consequence of the blowing up of asset price bubbles and Ponzi debt arrangements in the private sector. If current fiscal deficits had not been allowed to unfold, the Great Recession would now be the Great Depression 2.0.

Today, the putative bond market vigilantes are not wrapped around the axle about fiscal deficits in fiat currency countries, or for that matter in the northern countries that are members of the European Monetary Union (who de facto control the European Central Bank [ECB]). Indeed, their sovereign bonds are in great demand at low yields, just as should logically be expected when the developed-world private sector is running ever larger financial surpluses. Fiscal deficits are not crowding out private sector borrowing because the private sector doesn't want to borrow. Rather, fiscal deficits are facilitating the private sector's desire to save more, delevering their balance sheets. Remember, the government sector's liability is the private sector's asset!

But, you retort, the private sector is ultimately on the hook for the government's liabilities, so how can those liabilities be considered the private sector's asset? Simple: they can be sold for hard, cold cash. To be sure, someday the government's debt must be rolled over, or retired. But in real time, government securities are assets of the private sector (or the foreign sector). And for a fiat currency country, there is no reason to think that the debt cannot be rolled over, as such countries have a technology called a money printing press.

To be sure, using the printing press in the context of full employment would tend to generate higher inflation. But in the context of full employment, fiscal deficits would be dramatically lower—nothing like getting the unemployed off the dole and onto the tax rolls to cut fiscal deficits! And the developed world is a long, long way from full employment. Thus, front-loaded fiscal austerity makes absolutely no sense, unless you believe that Ricardo was right *and* that the private sector in the developed world has no balance sheet problems, only fear of future taxes. And that the moon is made of green cheese.

Bottom Line

What the developed world faces is a cyclical deficiency of aggregate demand, the product of a liquidity trap and the paradox of thrift, in the context of headwinds born of ongoing structural realignments. Front-loaded fiscal austerity would only add to that deflationary cocktail. And that's what the market vigilantes are wrapped around the axle about: they are not fleeing the sovereign debt of fiat currency countries but rather fleeing risk assets, which depend on growth for valuation support.

To be sure, the vigilantes have fled Greece, but Greece does not have a fiat currency; Greece is a risk asset, and all risk assets depend upon growth for valuation support. And fiscal austerity is not the path to growth if everybody wants to do it at the same time. The risk-asset vigilantes, who rightfully fear fiscal austerity–induced deflation, are in charge, not the bond market vigilantes of our youth, who feared fiscal profligacy–induced inflation.

These, my friends, are the facts on the ground. And they are not made easier by the reality of higher structural unemployment and a permanent reduction in the capacity for private sector credit creation in the developed world. What is more, secular fiscal positions in the developed world are bedeviled by the need to reduce and reorder fiscal expenditures associated with aging demographics. Longer term, a successful breakout phase in emerging economies offers much hope for stronger, better balanced global growth.

But cyclically speaking, current fiscal deficits in fiat currency countries are a blessing, not a curse. So, if you are cursing the lousy performance of your risk-asset portfolio, do not blame fear of fiscal deficits in fiat currency countries. Rather, blame fear of the austerians' desires to cyclically do something about them.

Notes

1. See Martin Wolf, "Why Plans for Early Fiscal Tightening Carry Global Risks." *Financial Times*, June 17, 2010.
2. Hats off to my friend and fellow Hy Minsky follower Rob Parenteau for recently coining this delightful word.