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2010

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Policy Response in 2010:
Building a foundation for the next growth phase

Nomura Research Institute, Ltd.

2010 brings sense of disappointment

Although the financial crisis is gradually receding into the past, the developed economies in 2010 have betrayed optimistic expectations that the world would return to normal once the crisis was over (Exhibit 1). This disappointment stems from the following realities:

1. Although the financial crisis is over, the ensuing recovery has been gradual.

2. The measures implemented to tackle the crisis were successful. However, economic stimulus programs have had a limited impact.

3. The response to the crisis resulted in larger fiscal deficits, and reducing those deficits will not be easy.

4. The financial crisis has many lessons to teach us, but as yet few measures have been put in place to prevent the next crisis.

5. Although international coordination thrived during the crisis, there is now increasing conflict between nations.

I would like to examine these issues with a focus on the US, the epicenter of the crisis.

Exhibit 1. Economic growth forecasts for 2010–11

	2010		2011	
	IMF	OECD	IMF	OECD
World	3.9%	---	4.3%	---
Industrialized nations	2.1%	1.9%	2.4%	2.5%
US	2.7%	2.5%	2.4%	2.8%
Japan	1.7%	1.8%	2.2%	2.0%

Source: NRI, based on IMF and OECD data

The realities behind the disappointment

When a financial crisis is triggered by a correction in the prices of overvalued assets, it involves a liquidation of the corresponding liabilities. Necessary adjustments resulting from the current crisis will place a heavy burden on households—not only did house prices rise substantially but households took advantage of those higher prices to increase leverage (Exhibit 2). With households the largest component of aggregate demand, the economy's potential for self-sustaining growth is almost certain to diminish.

There is no quick fix for stock adjustments. Using government money to recklessly buy up surplus assets and scrap them would lead to quick progress in stock adjustments, but this is not a realistic solution in a capitalism economy. All the authorities can do is to try to ease the pain of the adjustments. The US, for example, has sharply lowered its policy rate, eased the terms on home mortgage loans, and offered a tax credit for homebuyers.

While these measures have no doubt provided support for residential investment, households facing a sharply deteriorating labor market have found them irritatingly insufficient. To the extent that the measures taken in the midst of the financial panic were extremely effective, households may find it hard to conceal their impatience with the much less effective measures implemented since the crisis.

The chances of sharp reductions in the fiscal deficit are slim as long as the recovery proceeds at a gradual pace. A crisis demands large fiscal outlays, and in an ordinarily economic cycle the resulting fiscal deficits will shrink as the economy recovers. This time is "different", however, since the slow recovery has forced the government to turn to spending cuts in an attempt to pare the budget deficit. As the US experience in the 1980s demonstrates, the royal road to deficit reduction is economic growth; there are limits to how much can be accomplished with spending cuts alone if the government hopes to maintain necessary public services. Forcing through deficit-cutting measures at a time of economic instability also leaves the nation vulnerable to the fate that befell Japan in the late 1990s when it raised the consumption tax.

Economic packages have little immediate impact on stock adjustments, but they do have a strong impact on the capital markets. Shares and commodities have made substantial gains since spring 2009, and credit spreads have improved markedly as surviving banks, speculative

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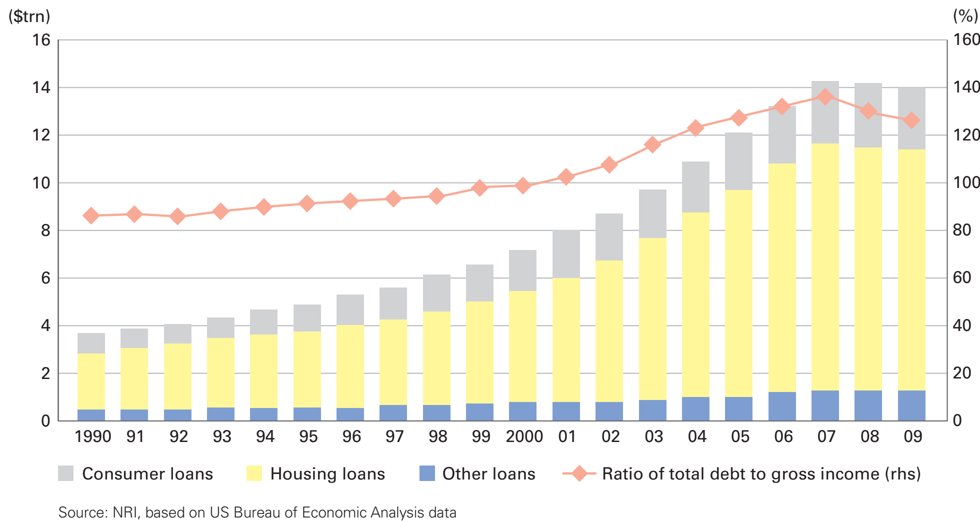
Exhibit 2. US household debt



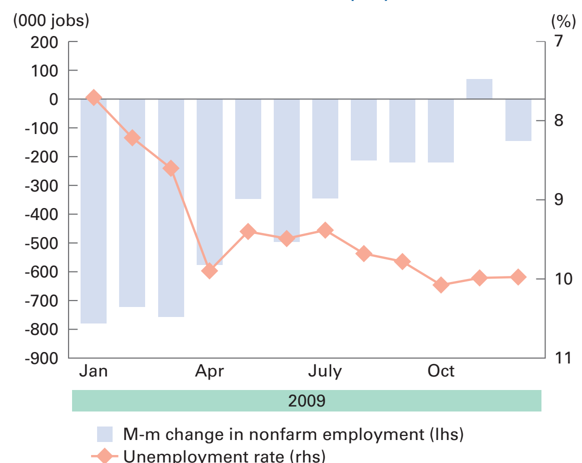
Source: NRI, based on US Bureau of Economic Analysis data

funds, institutional investors and other entities that were not seriously affected by the crisis took advantage of the favorable investment climate that followed.

But as the US Senate election in January 2010 suggests, the fact that the capital markets are thriving is of little consolation to those suffering from a depressed labor market (Exhibit 3). Voters are not only upset that the financial institutions at the heart of the financial crisis were rescued with taxpayer money and have gone on to earn high profits and pay large bonuses. Princeton professor Paul Krugman noted in a December 2009 column in the New York Times that the size of the work force, real incomes, and real housing prices in the US have not increased over the last decade. While the financial sector continued to grow despite a number of bubbles and crises, US households in effect experienced a "zero decade." When conditions are this polarized, the ideal of revamping financial regulation in light of the lessons of the financial crisis will come under assault from both sides. On one hand, a newly confident financial sector is now lobbying against regulation that would hamper its freedom to operate. On the other, an incensed US public seeks stronger control over the financial sector in order to receive the benefit of financial services.

But it is not just the capital markets that have benefited from the economic measures. The emerging economies, whose financial systems suffered relatively little damage in the crisis, have also profited from them. Exports to the rapidly growing emerging nations have become a major economic support for the US and other industrialized nations. At the same time, differences in the business cycle have hindered international coordination. It cannot be pleasant for the emerging economies to watch imports from industrialized countries increase while exports to those nations remain depressed. The dollar's weakness

Exhibit 3. US nonfarm employment and the unemployment rate



Source: NRI, based on US Bureau of Labor Statistics data

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may also be perceived as being unfair, even if not intended. If the developed nations continue to demand greater exchange rate flexibility and an end to dumping, it may be difficult to sustain the mood of global coordination fostered during the crisis.

Policy response requires longer-term perspective

Inasmuch as the problems facing the developed economies are intricately intertwined, a real solution will require a great deal of time. Seeking an easy way out would only delay the eventual recovery via larger fiscal deficits and the absence of necessary financial regulation. And a reckless attempt by the financial sector to recover its losses would signal a return to the cycle of global financial system crises that began in the 1990s, including the Asian currency crisis, LTCM debacle, the Internet bubble, and the current crisis. There is no magic bullet. The only way for economies to resume growing is for the authorities to do what they can to lighten the burden while households and the financial sector proceed slowly and steadily with stock adjustments.

One point of concern in this regard is the fact that many developed nations will hold national elections in 2010. It would be regrettable to waste time and money on short-sighted policies between now and the elections, even if we assume that strong post-election governments will be able to do what is necessary. Bipartisan cooperation is easily achieved in the midst of a financial crisis. However, policy coordination is more important after the crisis, when longer-term policies must be implemented.

The capital markets are one of the few areas in which policy can have a pronounced impact even after the crisis. It therefore makes sense to provide support to them first. Once the capital markets recover, not only financial firms but a wide range of entities can obtain the funds needed for economic activities. Resuscitating the financial sector can prop up the economy in the same way that robust exports have a spillover effect on the broader Japanese economy via employment and capital investment. While the spillover effect may be smaller for the financial sector than for manufacturing in terms of macro inputs and outputs, the impact on IT investment and hiring in the legal and accounting fields is non-negligible in the increasingly service-oriented economies of the developed nations.

Of course it is also important for the public authorities to establish a braking mechanism to prevent the financial sector from careening out of control again and sparking the next financial crisis. On this point, we need systems to enable the monitoring and resolution of large institutions as well as a “gapless” regulatory framework that ensures that similar businesses will be subject to similar regulations.

The only way for the government to deal with the increasing polarization of the economy is to engage in income redistribution. While this is clearly not an optimal solution in a market-based economy, maintaining public support is essential if the government is to implement policies that place a burden on taxpayers. Supporting household income is important in the sense that it eases the burden of the stock adjustments. On this point, the higher taxes on financial institutions being considered in the US and the UK could be effective. For the general public, conditions should improve markedly if the government can present credible methods and a realistic outlook for income redistribution.

Some may argue that it is not only the general public who cannot leisurely wait for policies to take effect, and that the financial markets themselves also need a quick boost from policy measures. But institutional investors are supposed to be in the business of longer-term investment. And it should be the role of the stock market and rating agencies to gauge the longer-term earnings potential of individual enterprises. Merely presenting a future policy outlook would be a great improvement over a situation in which the strategy for economic policy is ill-defined and the outlook is unclear.

Many of the prescriptions described in this article will be familiar to the Japanese. Unfortunately, Japan has been forced to revamp its policy response as the national consensus broke down and policies that had yet to run their course were overtaken by another economic crisis.

The most important task facing Japan is extensive re-allocation of economic resources. Japan was the only

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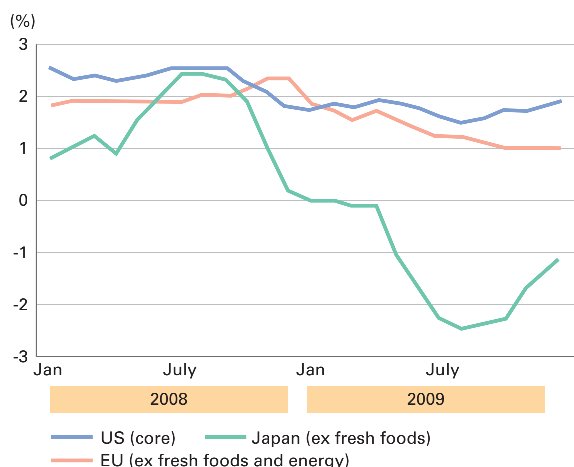
nation to fall back into deflation after the financial crisis (Exhibit 4). Modest and stable price declines will not trigger a crisis. However, a situation in which each shock to the economy produces another drop in prices is clearly not acceptable given the side effects of exchange rate fluctuations and a rise in real interest rates. If an economy develops pneumonia each time it is exposed to a common cold virus, something must be done to strengthen the economy and alter its makeup. The absence of inflation despite rising growth rates after Japan's previous financial crisis was an indication of macro-level inefficiencies of resource allocation. Although Japan was not an epicenter of the current crisis, Cabinet Office estimates show that the output gap has reached the unprecedented level of 7% of GDP. Stock adjustments may therefore be an even more pressing topic for Japan than for the US.

The second task facing Japan is the development of self-sustaining capital markets. The bank-centric nature of the local financial system is not in itself a pressing issue. But when banks—whether because of bad assets, excessive competition, or regulation—are not making loans, the mechanism by which financial and monetary policy transmits their effects throughout the broader economy via lending cannot function properly. The fact that US capital markets were able to support economic activity before bank functions were restored in the aftermath of the current crisis points to the importance of self-sustaining capital markets as a conduit for policy effects. Sustaining bank functions is important, but Japan also needs to adopt a longer-term perspective and begin work on the more time-consuming issue of establishing capital markets that are not excessively reliant on the banking sector.

Exhibit 4. Consumer price inflation in developed nations (y-y)



Source: NRI, based on various data

2010: a boring but important year

Even if the policies discussed in this article are implemented, 2010 is likely to be, at best, a boring period characterized by the dull pain of stock adjustments for the public, the financial system, and the authorities. Still, it is a road that must be traveled if we are to return to a better world, and in hindsight it could turn out to be a significant year.

The examples of successfully restructured companies demonstrate that the rebuilding process often starts out slowly but then builds momentum and ultimately finishes sooner than expected. For both the US and Japan, 2010 is a time to embark on a fundamental response to the issues at hand without undue pessimism or impatience.

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