

A **BY JØRGEN ØRSTRØM MØLLER**

# Misguided Missile

*Why did the Obama stimulus fail to lead to a significant increase in aggregate demand? Deleveraging of debt by households and lack of non-financial corporate investment.*

**H**ow things have changed! When I studied economics in the 1960s, debt was a non-issue. The acknowledged textbook was Richard A. Musgrave's *The Theory of Public Finance: A Study in Public Economy*, published in 1959. To the best of my recollection debt was a peripheral theme. Any student venturing into public debt risked being classified as slightly weird or at least having lost his or her orientation in the world of economics.

The U.S. public debt-to-GDP ratio was below 60 percent and falling, after having peaked in 1946 when war financing brought it to a level of 121 percent.

We were taught Keynesian economics and learned the virtue of fiscal stimulus in case aggregate demand was insufficient to ensure full employment. But the high priest himself did not, writing in 1930 and 1936, devote much attention to debt for the very reason that even after President Roosevelt's launch of the New Deal, the public debt-to-GDP ratio did not go much above 40 percent until 1941. In Britain where Keynes lived, public debt/GDP peaked at 181 percent in 1923 to fall steadily, passing below 150 percent in 1937 to reach 110 percent in 1940. Debt was manageable, and more than that, it actually fell over the Great Depression.

But four things taught by Keynes are carved in stone. The economy does not by itself move towards *full employment equilibrium*, we

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*These data confirm that the economic effects of public stimulus depend to a large degree on the private sector response in the form of total debt deleveraging.*

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talk about the *real* economy, what matters is *aggregate* demand, and fiscal stimulus is applied to *compensate* for a fall in private demand.

Faced with unemployment, fiscal stimulus does the trick only if aggregate demand goes up. A partial analysis looking at the immediate impact on investment and/or consumption of public demand boosting and/or lower taxes is not interesting. It comes to nothing if the private sector (consumers and investors) reacts adversely, offsetting the positive impact of the initial public stimulus. Reading the analyses and comments over several years on the American Recovery and Reinvestment Act of 2009, amounting to U.S. \$831 billion, this very simple lesson seems to be forgotten. Did the fiscal stimulus serve its purpose to *compensate* for falling private demand, keeping *aggregate* demand high, or did it not *compensate* for the fall in private spending, allowing *aggregate* demand to fall?

GDP fell in 2009 by 2.8 percent, rose in 2010 by 2.5 percent, and petered out in 2011 with 1.8 percent growth, to go up in 2012 only to fall again in 2013. These growth figures show that the American Recovery and Reinvestment Act actually managed to keep aggregate demand more or less at an unchanged level (slightly up), but failed in another respect. Fiscal stimulus is a temporary phenomenon, not a permanent one. The private sector must be convinced that the economy is back on track, luring consumers and investors to spend again and making further fiscal stimulus superfluous—who in their turn compensate for the fall in aggregate demand when fiscal stimulus is brought to a halt. The American Recovery and Reinvestment Act did not deliver a confidence boost among private investors and private consumers, private demand was kept low, and

consequently aggregate demand did not rise substantially on a permanent basis. But this reaction would hardly have been different with a more sizeable increase in the fiscal stimulus—either you believe this is the right way and react positively or you don't and react prudently by holding back on spending.

Many factors influence the response by the private sector and some of them fall outside an economic analysis. But the debt issue is certainly one of the most important factors, as businesses and individuals incorporate debt in their behavioral patterns for the simple reason that public debt has to be repaid—eventually and by them.

That debt is a real issue and must be repaid in one way or another also seems to be forgotten or put aside by mainstream economics. This is partly because the monetarists succeeded in obfuscating the issue by presenting debt largely as a monetary phenomenon. The argument is sometimes—frequently, actually—put forward that inflation reduces debt and deflation preserves it, even increasing its purchasing power. Such arguments rest solely and indeed superficially on a look at the balance sheets of businesses and individuals.

Yes, the item labeled “debt” may display lower figures as a percent of GDP in case of inflation, but does it mean that debt has somehow miraculously been reduced or wiped out with the stroke of a pen?

No. Debt means that a nation has overspent (overconsumed or overinvested) in the past compared to pro-

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duction. To use Keynes' vocabulary, aggregate demand has been higher than total production. The dictum not to be shirked is that repayment takes place, underspending (underconsuming or underinvesting) in the future compared to production—in exactly the same proportion. In an open economy, the balance of payments reflects that, betraying underspending (surplus) or overspending

## Disappointing Results

Household liabilities fell from about 135 percent of GDP before the financial crisis (2008) to about 100 percent by the end of 2013. This deleveraging took place simultaneously with a sharp increase in U.S. public debt and deficits.

—J. Møller

(deficit). With high inflation, creditors are deprived of savings' purchasing power, preventing them from consuming to compensate for their underspending in the past. The creditors' "non-spending" constitutes the repayment, allowing debtors to escape underspending.

The difference between various policy options can be summarized thus: What is the timespan for repayment (future underspending)? Taking hyperinflation in Germany in the 1920s, the timespan for repayment in the form of putting the burden on creditors was a couple of years. Who is supposed to shoulder the burden of underspending—creditors, debtors, private consumers, or private investors?

The "best" policy mix aims at getting the economy back on the growth track as soon as possible. Reestablishment of the debt-to-GDP ratio can be achieved through a lower absolute fall in spending (consumption and investment) because the GDP element as the denominator in the fraction goes up more than the numerator. This will only take place, however, through a demand pull.

A fiscal stimulus must therefore aim at groups or sectors in the economy having the lowest propensity to deleverage. The higher the share of the money pumped out that goes to debt deleveraging, the less the impact on the real economy will be. The lower the propensity to deleverage, the stronger the impact on the real economy will be.

Assume a fiscal stimulus uniquely composed of lower taxes for the consumer, for example, reducing the rate of a general sales tax. If the households' propensity to deleverage is 100 (every dollar used to deleverage—no demand pull), all of this will be channelled into reduced debt exposure, possibly in the form of lower mortgages. Assume the propensity to deleverage among households is nil; then the full amount will be spent on consumption (demand pull takes place). Or assume fiscal incentives to boost green energy; if the

propensity to deleverage is 100, all of this sum will be used to improve the balance sheet. Yes, investments in green energy may go up, but other investment projects will be scaled down to keep investment outlays at an unchanged level. In a way, this is nothing other than the well-known multiplier effect, except for incorporating how debt may influence it. The multiplier effect depends on the debt level and debt-to-GDP ratios in the main sectors of the economy.

It follows that it does not make much sense to debate the size of a fiscal stimulus. The crucial factor is whether it is directed at sectors with a low propensity to deleverage.

It is pertinent to ask why the private sector might use a fiscal stimulus to deleverage. The surmise is that it depends on the decision maker's belief in whether the efforts to strengthen the economy will work. If believed, then the opportunity is used to invest (it is cheaper to do so in an economy operating below capacity than when the business cycle improves) or consume (consumer prices especially for durable goods normally follow the economy on an upward trend). Neither households nor the business sector overlooks, however, that debt has to be repaid. They know very well that money given to them by the government, but borrowed, will have to be repaid, and that can only be done through higher taxes. The private sector therefore makes an evaluation of how the economy is going to perform and if not convinced of a sustainable recovery, chooses to save. It compensates for the initial fiscal stimulus by lower spending, keeping aggregate demand at a low level or even in some cases falling contrary to the intention behind the stimulus. We can borrow from Keynes—again—and talk about a "deleveraging trap" analogous to his description of the liquidity trap.

Data about deleveraging from the United States needs to be digested in this context. Household

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liabilities fell from about 135 percent of GDP before the financial crisis (2008) to about 100 percent by the end of 2013. This deleveraging took place simultaneously with a sharp increase in U.S. public debt and deficits. In 2009, the U.S. deficit was close to 10 percent of GDP. In 2012, when the public deficit fell substantially

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even if it was still at a significant level, deleveraging of household debt stopped, to be replaced by re-leveraging—total household debt went up again. Not surprisingly, economic growth jumped in 2012, reaching 2.8 percent compared to 1.8 percent in 2011 and 1.9 percent in 2013. The debt of major nonfinancial corporations has not decreased much. By far the strongest deleveraging has taken place in the financial sector, but that is small comfort as this sector's investments do not influence the real economy very much. The American Recovery and Reinvestment Act can be classified as a misguided missile in the sense that except for a short interval, it did not lead to a significant increase in aggregate demand, mainly because of deleveraging of debt among households and lack of investment among non-financial corporations. There is no reason to think that a more robust public stimulus would have changed this pattern.

Taken together, these data confirm that the economic effects of public stimulus depend to a large degree on the private sector response in the form of total debt deleveraging. Even if not conclusive, they also suggest that debt deleveraging in the private sector is correlated with debt and public deficits in the public sector. This forms the background for the theory of economists Carmen Reinhart and Kenneth Rogoff that if public debt surpasses 90 percent of GDP, further public borrowing to stimulate becomes counterproductive. That may be true or false. It may, however, be more rewarding to look at the sectoral savings imbalances and how they influence

economic transactions *inter alia*, and how households and corporations look at their own debt situations compared to future earnings—how strong is their respective balance sheet in view of expectations.

The policy conclusions to draw from these observations seem to be in favor of a mixture of fiscal and monetary policies that strike a balance between demand pull and deleveraging. It is not sufficient to boost demand if the burden of repayment stands unchanged or even worse goes up. Consumers and investors can see through the veil and react by deleveraging, keeping aggregate demand unchanged. Facilitating and encouraging deleveraging solely prevents demand from going up, imposing an intolerable size of repayment on a stagnating economy.

The United States has tried to wriggle out of this dilemma since 2008 without much success because households were mired in debt far above what is considered normal. The U.S. consumer is not ready to splash the cash, fearing future taxes. The eurozone countries are different case by case, but generally the household debt-to-GDP ratio is lower, explaining why deleveraging of household debt has not been a major issue while the higher debt ratio for corporations has kept investment low with money going into balance sheet improvement. Japan has tried for fifteen years, but hit the same stone wall year after year. The explanation may be Japan's unique demography.

The balance of payments tells the story. Since the introduction of policies to address the negative impact on the real economy from the financial crisis were put in place, the U.S. deficit has fallen from around 4 percent of GDP to 2.5–3 percent. The eurozone has turned around from a deficit of 1 percent of GDP to building a sizeable surplus now running at approximately 2.5 percent of GDP. Japan's large surplus of about 3 percent is now less than 1 percent and falling, auguring balance in 2017, maybe even 2016. The interpretation is an American and eurozone bias in favor of deleveraging. Reading policy statements from the United States, this does not seem deliberate, while that may have been the case for the eurozone. Japan is moving in the opposite direction and according to official statements that may be deliberate.

No wonder that it is so difficult to engineer a global recovery. Three of the four biggest economies are mired in debt and they have not managed to get to grips with the right policy mix in view of debt-to-GDP ratios for their domestic economic sectors, and even worse to coordinate their response going for a global balance between debt deleveraging and boosting their combined aggregate demand. ◆