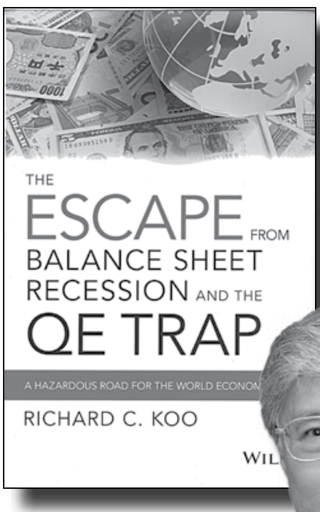
My Plan *to* Save the World

Leading economist Richard Koo of Nomura Research Institute sat down with TIE *founder and editor David Smick to discuss balance sheet recessions and what policymakers need to do to rescue their economies.*



RICHARD KOO

Smick: Your 2008 book, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession,* was a very important work. What's the difference between that effort and your most recent book, *The Escape from Balance Sheet Recession and the QE Trap: A Hazardous Road for the World Economy*? What did you need to say that you hadn't already said?

Koo: The purpose of *The Holy Grail* was to make sure the United States would not make the same economic policy mistakes Japan had made, and would avoid suffering from the disease I call "balance sheet recession." Against the advice of then-U.S. Treasury Secretary Larry Summers, Japan made a terrible mistake in 1997 in adopting a policy of fiscal austerity. The result was five consecutive quarters of negative growth and a complete breakdown of the banking system. It took Japan ten years to recover from that mistake. Although the United States avoided the mistake, the Europeans walked right into it, which is one reason I had to write the new book.

Smick: You mentioned something about *New York Times* columnist Paul Krugman?

Koo: Even though Paul later came to appreciate the need for fiscal stimulus, at the beginning he was still very much in favor of action on the monetary side. But such a recession—what I call a balance sheet recession, where the private sector got itself involved in a bubble, the bubble burst, liabilities remained, asset prices collapsed, and everyone had to repair their balance sheets—only happens once every several decades, but when it happens, monetary policy is largely useless. The second part of *The Holy Grail* warns readers that relying on monetary policy won't work. Inflation will not pick up. The economy will not begin to move.

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My new book has two parts. The first part looks at the U.S. experience with quantitative easing. I didn't think QE was a good way to go, but since the United States did it, now we need to consider how to come out of it. My thinking suggests that this process is going to be very bumpy and very difficult, and I want to warn that it could result in some very nasty surprises. And we have been experiencing this bumpy ride in the markets since last year. I also want to save Europe. My first book helped the United States in a small way, but it didn't address the problems Europeans were facing. So I devoted a chapter to advice on basically how to save Europe.

Smick: A lot of people say U.S. policymakers were surprised when, in response to the 2008 financial crisis and despite a trillion dollars of combined Bush and Obama fiscal stimulus, the American people said "Now we're going to repair our balance sheets. We're not going to spend." At the same time, European corporations became obsessed with their balance sheets. Do you get the sense that in both the United States and Europe, individual decision makers reacted in a way that made the stimulus less effective?

Koo: The private sector has to minimize debt when its balance sheets are underwater. If the United States had not enacted that massive stimulus package, the situation would have been even more catastrophic. As soon as the Lehman crisis hit, the U.S. private sector started saving something close to 10 percent of GDP, despite zero interest rates. At zero interest rates, Americans are supposed to be borrowing money, not saving money! But because the bursting of the bubble left them with lots of debt but no assets to show for it, the U.S. private sector went from being massive borrowers to the tune of 5 percent of GDP to massive savers. Something like 15 percent of GDP was lost literally overnight when people changed their behavior.

But in the national economy, when someone is saving money, someone else needs to be borrowing money to keep the economy going. I'm glad people in the Obama Administration understood that. The government became the borrower of last resort and that's what kept the economy going.

Europeans, on the other hand, misunderstood the Japanese experience. They convinced themselves that Japan was suffering from its long recession because of a lack of structural reform and banking cleanup. Some American opinion leaders spouted similar nonsense. Japan did have those problems, but they don't explain the sudden collapse of the Japanese economy after 1990 and why it stayed so weak for so long. Thus, when the Europeans got themselves into a similar problem, they thought they had to do structural reform and clean up the banking system as quickly as possible. But when you have a balance sheet problem, those are the wrong things to do. As a result, the state of Europe's economy remains very poor.

Much of what happened in Europe was perfectly predictable. In 2003, in my first English-language book, *Balance Sheet Recession: Japan's Struggle with Uncharted Economics and Its Global Implications,* I clearly said that when Europe enters a balance sheet recession, the European Union should allow member governments to borrow more than 3 percent of GDP, because the private sector could be saving 7–10 percent of GDP. And that's basically what happened. In *The Holy Grail,* my second book, I mentioned that if the government fails to act, there will be a crisis of democracy because the people become desperate. And desperate people will start voting for populists, national socialists, and those kinds of parties, similar to what happened in Germany in 1933. I really want to warn the Europeans that they have to change course because both of those things are coming true.

For the last twenty-five years or so, economics departments around the world have been taken over by people who think monetary policy can solve all problems.

Smick: Describe the QE trap and how we can avoid it.

Koo: The QE trap refers to the difficulty of removing the massive amounts of liquidity that are already in the banking system. Actually, I don't know how we can avoid it. The question is how can we minimize the problem. QE is like the unwanted child of a balance sheet recession. During a balance sheet recession, the private sector is deleveraging to remove its debt overhang, so it's not borrowing money. Unless something is done, the economy goes deeper into recession because everyone is saving and nobody is borrowing. With a recession, the central bank cannot simply stand still so it brings rates down, but nothing happens because people are repairing their balance sheets. Even at zero interest rates, nothing happens.

At that point, policymakers should say, "Ok, that's the end of monetary policy's usefulness." But for the last twenty-five years or so, economics departments around the world have been taken over by people who think monetary policy can solve all problems. These people said, "Well, price doesn't work, so let's try quantity, and more quantity until something happens." But there's still no reason for anything to happen because those repairing their balance sheets won't borrow money at any interest rate.

QE is like the unwanted child of a balance sheet recession.

At some point, however, the private sector finishes repairing its balance sheet and is ready to borrow again. At that time, the Fed will have to remove or sterilize the $2.4 trillion excess reserves in the banking system, which is sixteen times the required reserves. And that is when the real cost of QE or what I called the "QE trap" becomes apparent.

Smick: Do you think because monetary policy came to the rescue during the 1987 crash and the economy didn't go into a recession, investors developed this false confidence about monetary policy being able to protect the economy during a financial panic?

Koo: The infatuation with monetary policy began with the "discovery" that when the Federal Reserve increased the monetary base from 1933 to 1936, the money supply grew very rapidly. The economy also recovered very rapidly. From 1929 to 1933 the Fed really hadn't done much, so economists assumed the increase in the monetary base must be the reason the U.S. economy recovered from the Great Depression.

It is true that the money supply grew and the economy grew as well, but they forgot to check one thing. Money supply is a liability of the banking system—basically bank deposits all added together. For the money supply to grow—the liability side of the banking system—the asset side has to grow also. The academics forgot to look at what was increasing on the asset side of the banks' balance sheets from 1933 to 1936.

When you look, you will notice lending to the government accounted for all the increase from 1933 to 1936. Lending to the private sector did not increase one cent during those years. President Roosevelt's New Deal policy, where government had to borrow money to do all those projects, filled the gap left by private sector deleveraging. The public sector came in to borrow. Money was able to leave the banking system and enter the real economy. Then the money multiplier turned positive, and that's how the U.S. economy recovered.

Those people who understood that point, including former Chairman Ben Bernanke and current Chair Janet Yellen at the Fed, started talking about fiscal cliff. If the private sector as a group was saving 10 percent of GDP, and the government refused to borrow this surplus savings, then the economy would shrink 10 percent per year. But if the government borrowed and spent what the private sector was saving, then both the money supply and GDP are maintained. The United States and President Obama did all the right things. That's why the United States is doing much better. But the Europeans never understood. They're still talking about reducing fiscal deficits at the same time as the Spanish private sector is saving 7 percent of GDP, and the Portuguese private sector is saving 6 percent of GDP. To make matters worse, under the terms of the Maastricht Treaty, eurozone member governments can only borrow a maximum of 3 percent of GDP.

Smick: Who do you blame? The Germans? Many commentators complain that they should have expanded fiscal policy.

Koo: In terms of blame, the Maastricht Treaty introduced the 3 percent rule for European economies preparing to adopt the euro. Back then, only people in Japan knew anything about balance sheet recessions. The concept was not in economic textbooks, nor in the lexicon of economic vocabulary, so I cannot blame the Treaty negotiators for not thinking about this possibility. The economics profession as a group is still not mature enough to encompass all macroeconomic possibilities. And when the financial crisis happened, Germans of course said, "We all agreed to the 3 percent rule, why change now?" I see that Germans like to follow rules, but it's like building a new airplane. When you actually put it together and flight test it, there could be a few glitches. This is one of those glitches they haven't thought about.

Smick: I admit that the United States has performed better. Unlike Europe, the United States bailed out its

banking system. Now it's much better capitalized and seems healthier. Compared to the Europeans, there was a better response. To what extent do you think issues related to confidence, like Washington's ongoing partisan knife fight, impede decision-making for consumers, investors, and the entrepreneurial sector?

Koo: You mention banking. I worked on the Latin American debt crisis when I was at the New York Fed, and that was a huge fiasco. In August 1982, Mexico went belly-up and seven out of eight U.S. money center banks went bankrupt. I was in the middle of it because I was in charge of the syndicated loan market at the New York Fed.

When a crisis of that magnitude hits, I find the U.S. government suddenly becoming extremely pragmatic. Then-Fed Chairman Paul Volcker told us to "request" each of the hundreds of American banks involved to continue lending to Mexico, knowing full well that Mexico was bankrupt. He came up with that directive because if one bank tried to pull out, then everyone would want to pull out at the same time and everything would collapse. We saw in the leadership that kind of very rapid change in the mindset—it was probably illegal to tell banks to continue lending to a bankrupt borrower, but we still had to do it to save the whole world.

This time around, we again saw that same pragmatism in the United States. In October 2009, commercial real estate prices were falling. Everyone was waiting for the other shoe to drop. The Federal Reserve, the FDIC, and the Comptroller of the Currency then jointly backed a pretend-and-extend policy. Pretend that everything is fine, and continue rolling over the debt. At that time, U.S. commercial real estate was already down 40 percent from the peak, which meant if the regular rules were applied, the debt shouldn't have been rolled over. But if it hadn't been rolled over, then the whole world would have collapsed and that would have been the end of the U.S. economy.

Smick: They suspended mark-to-market?

Koo: Exactly. So U.S. policymakers relatively early in the process did what was necessary, which is why commercial real estate was doing so much better later on. Europeans didn't do anything like that, just a few capital injections when things really went bad at the very beginning. But then European policymakers start talking about raising capital requirements, doing bail-ins, and other policy actions that, taken individually, are correct, but taken together become a fallacy of composition. As a result, European banks never really recovered because they were not given the chance to pull themselves together, adding to European debtor problems. As far as banking is concerned, I think the United States did a good job with the pretend-and-extend because that's basically what I was told to do back in 1982.

Now on the behavioral part. In order to become a hero, the crisis has to happen first, like in Hollywood movies. Look at what happened to the Obama Administration. President Obama, White House economic adviser Larry Summers, and others took all the necessary steps in the first year or two. That kept the economy from collapsing, but it also required a large $788 billion fiscal stimulus on top of the stimulus President Bush had done. As a result, nothing horrible happened. But then the people came back and said, "Look, you spent $1 trillion and nothing happened. You must have wasted this money on the most useless projects." Then they go around with a microscope and they find a few useless projects. That's exactly what happened in Japan during this process, too. Journalists with nothing better to do went around the country and concentrated on a few spending projects that were really stupid.

Money supply is a liability of the banking system.

I'm not saying that stupid things don't happen. But at that time, the government had to act as the borrower of last resort to keep the economy from collapsing, given the horrible health the private sector was in. On top of it, we didn't have any name for this type of recession caused by the private sector minimizing debt. Economic professionals assume the private sector is always trying to maximize profits, so if monetary authorities bring real rates low enough, then at some point the borrowers come back and the economy improves. Most of the time that is true, but every several decades when the private sector goes crazy over a bubble, that fundamental assumption is violated. The private sector is no longer maximizing profits but instead is minimizing debt.

We were all taught in universities that a government deficit is something bad. It misallocates resources through pork-barrel politics, and leads to inflation and higher interest rates that crowd out investment. For those of us who were trained in that school, our natural reaction is that big government is bad government. For this

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reason, it is very difficult in a democracy during peacetime to sustain the necessary fiscal stimulus until private sector balance sheets are restored. That is why it takes so long for democracies to come out of these recessions. In wartime, no one asks where the money's spent—it goes for fighter planes and tanks—and recovery can happen quickly. In a dictatorship, the dictator can just order everything necessary to be done and that economy can come out of these recessions quickly as well.

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And with no name for this type of recession, it was as if a bunch of doctors see a patient who is not responding to ordinary treatment. They come up with wildly different ideas on how to cure the patient, resulting in massive confusion. But if they know the patient suffers from pneumonia, then there will be no more debate about treatment. There's no Democratic or Republican way of curing pneumonia.

Smick: What's your message to Europe about how to get out of their current mess without the risk of huge political fallout?

Koo: Those who understand a problem emphasize its simplicity. Those who don't, emphasize its complexity. I think I understand the problem because I was able to predict the difficulty Europe would face after the bubble, including the political problems. The only thing I could not predict is the refugee crisis.

Understand why we have this problem: The Spanish private sector is saving 7 percent of GDP to repair its balance sheets while the government is only allowed to borrow 3 percent, and the remaining 4 percent ends up becoming a deflationary gap, and the state of the economy remains very poor as a result. The authors of the Maastricht Treaty never anticipated something like this would happen—that the private sector would save more than 3 percent of GDP at zero interest rates. That was not in our economic textbooks back in college. But that is the reality we have been facing since 2008.

My suggestion has two parts. First, they should add a provision to the Maastricht treaty so that government can borrow more than 3 percent of GDP when the private sector is saving more than 3 percent of GDP at zero interest rates. With this provision, Europe will be able to handle both ordinary as well as balance sheet recessions while maintaining the original spirit of the 3 percent rule.

The second part has to do with a euro-specific problem that even I failed to anticipate. In all countries, there are many investors and pension fund managers who cannot take too much foreign exchange risk and cannot put all their money in stocks. They need fixed-income assets denominated in domestic currency. When an economy falls into balance sheet recession, the only borrower left issuing fixed-income assets is the government. So all their funds start going into the government bond market. That's the reason government bond yields fall to these ridiculously low levels during this type of recession.

Lots of people in the American hedge fund industry didn't understand this, so they tried to short the Japanese government bond market over and over again. They all lost money on that trade because the low yield was not a bubble, but rather the market's way of urging the government to do more fiscal stimulus to save both the money supply and the economy. This is what I call the self-correcting mechanism of balance sheet recession. Bond yields come down to encourage the government to borrow and spend the excess private sector savings, then the economy comes out of its recession.

We don't need German fiscal stimulus. We don't need more negative interest rates or money printing by the European Central Bank.

The problem is that this mechanism doesn't work well in the eurozone because they have nineteen different government bond markets within the same currency zone. Spanish investors don't have to buy Spanish government bonds—they can buy German, Dutch, or Finnish government bonds without incurring foreign exchange risk. This capital flight from countries generating excess savings causes all sorts of instability within the eurozone that does not happen anywhere else.

To correct this problem, I've suggested we change the risk weights a little. If an investor holds his own government's bond, the risk weight on his holdings is still zero. But if he holds another government's bond, the risk weight is a little higher. This encourages Spanish excess saving to go into Spanish government bonds, for example, and assures the Spanish government that the needed stimulus can be fully financed. Then all the economies in Europe would benefit.

My point is that we don't need German fiscal stimulus. Germany is already at full employment—its unemployment rate is only 4.3 percent. We don't need German taxpayer money because countries like Spain and Portugal already have massive private sector savings to finance needed fiscal stimulus. We don't need fiscal union because this can be done independently of any euro setup. We don't need more negative interest rates or money printing by the European Central Bank because those policies do not provide solutions to balance sheet problems.

Put all this together, and even the Germans should come to conclusion that they should allow the Spanish government to fix its problem with Spanish savings so that everybody else including the European Central Bank won't have to do anything crazy.

Smick: That would be a pretty easy fix.

Koo: Once you understand the nature of the problem, it's actually very straightforward. My two-pronged approach should also have the least political fall-out because it basically costs nothing to the Germans or to the European Union.

Smick: The rush into the U.S. ten-year Treasury bond and to a certain extent Japanese government bonds represents a flight to safety.

Koo: Once investors see that Spain is doing all the right things to come out of its balance sheet recession, then I'm sure Spanish investors would rather have Spanish bonds than German bonds yielding next to nothing. Recovery becomes a self-fulfilling prophecy.

Smick: You argue that the West has forgotten a major lesson on China and its history. Can you elaborate?

Koo: A lot of people talk about rebalancing the Chinese economy. Looking at current consumption and investment, their economy appears to need lots of rebalancing. But you have to realize that China just passed what economists call a "Lewis turning point," named after economist Arthur Lewis, which is when all the surplus workers in the countryside are fully absorbed into the city factories. In the West, that happened nearly one hundred years ago. But in China, it has happened only recently, in the last five years.

Prior to hitting the Lewis turning point, growth has to be capital-driven because the workers do not earn much pay. There are so many of them in the countryside and their wages are depressed, and so by definition inequality gets worse and worse. But once an economy passes the Lewis turning point and there are no more excess workers in the countryside, then wages start rising very rapidly, the masses get a huge pay increase, and inequality corrects itself. Automatically, consumption becomes a much greater share of the economy and investment becomes a much smaller share.

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Rebalancing is already happening in China. If you talk to upper-income people in China, they say the economy's doing poorly. But if you talk to the lower 40 percent of wage earners, they are doing very well because their wages are growing 10 percent per year. They're spending tons of money. We should not compare China today with the United States today. We should compare China today with the West around the time of World War I. Then actually China is doing quite well—Europeans at the turn of the century worked a 14–16 hour day. Chinese workers are passing the Lewis turning point and only working eight hours a day.

Smick: There's a sense that China in the last ten or fifteen years has picked a lot of the low-hanging fruit. The global economy was doing quite well, so they were doing quite well. There was a generosity of spirit after the fall of Berlin Wall. The industrialized world was going to absorb all these new workers into its global work force. That's changed. China is being forced to shift to becoming a consumer nation. Presidential candidate Bernie Sanders actively went after China and the WTO. The industrialized world is going to be much more aggressive against China.

Koo: One thing that needs to be mentioned is that China is the only country that had a huge increase in imports after the Lehman crisis. This means China was the one supporting the global world economy after 2008, not the other way around. Instead of bashing the Chinese, we should appreciate the fact that they put in massive fiscal stimulus to keep their economy going.

China is the first government to understand the whole concept of balance sheet recession. My book *The Holy Grail of Macroeconomics* was published in March 2008, and the Chinese version was out by November 2008. That's the same month China's ¥4 trillion fiscal stimulus package was implemented. A lot of Chinese economists told me they read my 2003 book, *Balance Sheet Recession,* to understand what to do when something like this happened. Since China is a dictatorship, its government can do these things quickly, unlike a democracy in peacetime.

Smick: China has shifted to an investment-led model, but they now have massive debt and a lot of urban infrastructure sitting empty.

Koo: The working-age population in China is already shrinking, and wages are rising because China has passed the Lewis turning point. If China can't figure out how to make these workers produce more efficiently and productively, then there will be no more growth. China's President Xi Jinping fully understands that.

You should also note that while the old economy of China was characterized by overcapacity and huge debt owed mostly by state-owned enterprises, the new economy of China is very vibrant. Many American investors who put their money in Silicon Valley are now invested in similar ventures in China because they realize the tech community there is just as bright, and just as entrepreneurial. One investor told me now half of his money goes to Chinese ventures instead of those in Silicon Valley.

When China had so many workers in the countryside looking for jobs in the cities, its first priority was to provide enough capital so that these people could be gainfully employed. To attract capital from abroad, they needed to put in the necessary infrastructure. For that, the Communist system actually worked very well. China can build a highway in three months that would take thirty years in Japan, because just property rights alone would be so difficult to handle. Now that world is over for them. To increase the productivity of individual workers now, China needs market forces because state-owned enterprises are not very good at allocating resources efficiently which is essential for increasing productivity. But deregulating the Chinese economy all at once would make far too many enemies all at once for Mr. Xi.

Smick: My concern is the complete breakdown of the free trade consensus. We're seeing a rollback of globalization, except ironically the globalization of information is rising. The world is going to be tougher for the Chinese. The re-regionalization of the global economy is happening.

Koo: I also sense the opposition to free trade in all advanced countries, but this is not the first time. Just before the Plaza Accord in 1985, Capitol Hill was full of protectionists. I remember that world very well, when only Coca-Cola and Boeing were for free trade. I even represented U.S. trade positions in numerous Japanese TV programs at the height of U.S.-Japan trade friction at the behest of the U.S. embassy in Tokyo. That was not a pleasant experience at all, and I think we are seeing a repeat.

The U.S. dollar was relatively weak until September 2014. When the Federal Reserve said it was going to normalize monetary policy, the dollar became the strongest currency in the world, rising 50 percent against the Mexican peso and 37 percent against the Canadian dollar. I'm sure that scared a lot of blue-collar workers here. By the way, this sort of market reaction is part of what I called the QE trap. But if we could somehow contain this dollar appreciation, maybe we can contain this threat to free trade. And suddenly U.S. Treasury Secretary Jack Lew and others have started talking about keeping the dollar low or removing factors that push the dollar higher, which means Federal Reserve tightening. That's all happening right now and it reminds me of the Plaza Accord of 1985.

The United States and President Obama did all the right things. That's why the United States is doing much better. But the Europeans never understood.

Smick: Thank you very much. ◆