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How (not) to lose a decade

Abstract

Recovery from the Great Recession has been fraught with problems. The recovery has not been behaving like the aftermath of a typical cyclical recession, and this is because we are instead in the midst of an ongoing *debt crisis*. Debt crises are different, both economically and politically. Politically, debt crises lead to conflict over how the burden of adjustment will be distributed. And this conflict can seriously delay measures to alleviate the impact of the crisis – making everyone involved worse off. Theory and history suggest a variety of factors that make this sort of counter-productive conflict and delay more likely; and they also suggest possible ways to reduce both the conflict and the social cost of its consequences.

The world has known a long and dismal array of lost decades, in which societies have stagnated economically, and often politically and socially as well. The sad catalogue goes back at least 200 years, and we are now adding to it. The decade past has already been lost to the advanced industrial world: whatever economic advances were realized between 2002 and 2007 were wiped out by the Great Recession that began at the end of 2007 and whose effects are still with us. Now we stand poised to lose another decade, as economic stagnation and political polarization have paralyzed the United States and Europe. In this context, it is worth asking what theory and history have to teach us about the causes of lost decades past – and how we can avoid joining them in the future.

We fear for the current decade because recovery from the Great Recession has been fraught with problems. The recession was, to be sure, both the longest and deepest

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economic decline since the 1930s, but that is not all. Europe has fallen into its second recession in five years, and there are few signs that real economic growth will resume soon. The American economy is growing again, but it has taken an inordinately long time to get back to pre-recession levels, and employment is lagging years behind what we are used to see in the wake of typical American recessions . Whether in Europe or the United States, this does not feel like the aftermath of a typical cyclical downturn.

It does not feel like the aftermath of a typical cyclical recession, because it is not: we are instead in the midst of an ongoing *debt crisis*. Debt crises are familiar, both from the experience of such developing and transitional economies as Turkey, Brazil, Thailand, and Mexico, and of centuries of such crises – including in the United States. And we know that debt crises are different. Carmen Reinhart and Kenneth Rogoff have shown with stunning statistical clarity how, over the course of eight centuries, debt crises have differed economically from "normal" recessions.[1] Debt crises are also different politically.

A global debt crisis

The crucial economic features of a debt crisis are on display on both sides of the Atlantic. An economy recovering from such a crisis is saddled with a mass of accumulated debts, which retard recovery. This "debt overhang" affects both creditors and debtors. On the creditor side, American and European banks hold trillions of dollars in debts, many of which they know to be bad, others of which they fear may be bad. In these circumstances, financial institutions are primarily concerned to shore up their balance sheets – to “deleverage” by shedding bad and questionable assets. They are very wary of making new loans, especially to marginal borrowers. This reticence to lend hinders a normal recovery, and both the Federal Reserve and the European Central Bank have expressed their frustration at the slow pace at which new lending has proceeded.

The debt overhang exerts a similar drag on debtors. Indebted households have experienced a series of shocks: to their income and perhaps their employment, and to the value of their assets including their homes. All this reduces their disposable income, but their debt burdens remain. The only way households can meet their obligations, and rebuild their savings, is to reduce consumption.

Banks aren’t lending, and consumers aren’t spending, and this is the principal explanation for the halting nature of the current recovery. There is, however, something of a conundrum here. Both creditors and debtors *could* conceivably be made better off by a deal that restructured debts to make them more manageable. Creditors would gain inasmuch as bad debts would be made better – after all, a little of something is better than all of nothing – so as to allow them to rebuild their portfolios. Debtors would gain by stringing out, or reducing, debt service payments so as to impose less of a drain on current consumption. This is why we have bankruptcy courts and similar proceedings.

Neither the creditors of a company in trouble, nor the principals of the company, gain if the company is driven out of business; both sides are better off if the company can be rebuilt as a going concern. So why have creditors and debtors in this debt crisis – as in many before it – found it so difficult to reach a mutually beneficial arrangement to restructure debts and resolve the problems created by the debt overhang?

The answer is that debt crises are inherently political. Every debt crisis leads to bitter political conflict, for simple reasons. Economists characterize the starting point as "the asymmetry of the adjustment burden." That is, in a debt crisis (as in a balance of payments crisis) the debtor has no choice but to adjust its finances if it wants to continue to service its debt: it has to generate the resources to pay off creditors. This stress is magnified if, as has happened to many sovereign and household debtors in the current crisis, one result is that they are cut off from continued access to credit. Debtors cannot continue to borrow, and have to service their debts. Creditors, on the other hand, are under no such pressure. They do not have to lend out more money, which they can park in such riskless assets as the government securities of major financial centers, or in cash. This makes the burden of dealing with the crisis disproportionate ("asymmetric"), for debtors *have* to adjust while creditors do not.

However, this economic asymmetry is just the starting point. It is true that creditors, in this sense, hold the whip hand: they can sit back and wait for debtors to repay them. But debtors have *political* tools in their arsenals. Debtors can counteract the economic asymmetry of the adjustment burden with their own political action, in particular by refusing to pay. And, especially in the case of sovereign debtors, this is a powerful weapon, as a sovereign default could threaten the solvency of major financial institutions, or even the stability of creditor-country financial markets.

The economic asymmetry of the adjustment burden, in other words, creates a political backlash. Keynes is said to have observed, “If I owe my bank manager a thousand pounds, I am at his mercy; if I owe him a million pounds, he is at my mercy,” and the logic here is similar.

Debt crisis politics

Debt crises, then, invariably turn into political battles over who will make the sacrifices demanded by the accumulated debts. These battles are typically fought on two dimensions, international and domestic. Internationally, creditor countries square off against debtor countries: creditors want to be paid as much as possible, while debtors want to reduce their obligations by as much as they can. This drama is currently being played out in Europe, as it has been played out in countless sovereign debt crises in the past. In the American case, there is less evident international discord over the country’s debt to foreigners, although we have seen some early indications of a politicization of the country’s foreign debt.

The second dimension of conflict over the distribution of the adjustment burden is domestic. Who, within a nation, will be asked to pay the principal price for dealing with the implications of the crisis? This is true even in the case of creditor countries – in Germany today, there are questions about whether the losses realized from foreign debts gone bad should be made up by the financial sector, by taxpayers, or by others. In debtor countries, such as those on the European periphery, the issue has been the centerpiece of political strife for several years: in Greece, Portugal, Spain, Ireland, will it be government employees, taxpayers, beneficiaries of government programs, or others to bear the burden of dealing with the nation's obligations?

We have a great deal of experience with this sort of backlash. In the interwar period, foreign debts – including the closely related war debts and German reparations – were central to international and domestic political conflict from the moment the crisis began in 1929. In fact, every country that was a net foreign debtor as of 1929 moved dramatically toward some form of authoritarianism afterwards – Nazism, reactionary military rule, extreme economic nationalism, or militarism. No net creditor country did so. And it is easy to understand why: for the debtors, the enemies were foreigners, bankers, international markets, perhaps markets in general. The result was a massive backlash against the open world economy that had prevailed before 1914, and briefly in the 1920s, and that was regarded by debtors in crisis as the source of their distress.

The political aftermath of the Latin American debt crisis that began in the early 1980s was more positive, as most of the region's countries democratized. This was probably because the governments in power when the region collapsed were largely authoritarian, so that military dictatorships took the blame (rightly) for the crisis. But crisis-borne conflicts over economic policy beset the region for most of the decade, and made progress difficult. And in some Latin American countries with democratic systems, the debt crisis led to serious political disruptions. Venezuela is probably the best example, for the country's long-standing democratic party system effectively collapsed because it could not find its way out of the crisis.

Today, the Eurozone finds itself mired in just this sort of political conflict, both among nations and within them. It is unlikely to lead to the sort of dire outcomes we saw in the 1930s, but the crisis has threatened the political stability of a number of European debtor nations.

In the United States, the conflict is somewhat more muted. This is in part because, unlike the European debtors, the United States has not faced a "sudden stop," in which foreign lenders abruptly decide they will not lend, or will lend only at prohibitive interest rates. It is also in part because so much of the American debt problem is one of households, not governments, and so the battle lines are not so clear. Nonetheless, there are plenty of indications of fundamental political conflicts over economic policy, from the bitter campaign against the Obama administration's fiscal stimulus to vitriolic attacks on the Federal Reserve's monetary policy. These largely reflect the divergent interests at play. Taxpayers less hard hit by the crisis see no reason to accumulate further obligations in order to assist those who were most affected. Savers (especially among elderly retirees) view today's extremely low interest rates primarily as a blow to their ability to live on their savings, undertaken for a vague promise of growth in output and employment which is largely irrelevant to them.

In many, perhaps most, cases, these crisis-driven political battles turn into a sort of game of Chicken. Creditors threaten to cut debtors off from further funds, and to punish them; debtors threaten to withhold payment; and the first side to flinch loses. This war of attrition can drag on for years, delaying an ultimate settlement. In the case of Latin America, domestic and international clashes continued for seven years until finally, in 1989, the Brady Plan oversaw a comprehensive restructuring of sovereign debts that eventually allowed an exit from the region's lost decade. In Japan after 1990, the unwillingness or inability of the government to confront the effects of the insolvency of some of the country's leading banks and corporations, and continued skirmishes over who would pay to keep the merry-go-round moving, prolonged the country's own lost decade until at least 2003. Today, as Menzie Chinn and I wrote in our *Lost Decades: The Making of America's Debt Crisis and the Long Recovery*:

> Financial interests resist regulations that shift the burden of risky behavior back onto them and off of the taxpayer. Beneficiaries of government programs fight against attempts to curb their benefits. Taxpayers refuse to pay the taxes needed to pay for the programs they want. Partisan politicians block reasoned discussion, suggesting absurd pseudo-solutions instead of realistic alternatives.

> Ideologues and political opportunists encourage Americans to cling to the childish things that have served us so poorly in the past….

In all these cases and more, delay is especially worrisome, as it raises the final cost of the settlement itself – not only economically but socially and politically.

Declaring a war of attrition

Political polarization can paralyze attempts to resolve a debt crisis, driving the principals into a costly and lengthy war of attrition. Each side launches threats and ultimatums, stakes out intransigent positions, tries to force the hand of protagonists – and meanwhile the crisis worsens as the parties become even more extreme and resolution even more difficult. What does experience tell us about what makes such a war of attrition more likely – and, more positively, how we might avoid a descent into this downward spiral? Let us start with understanding the reasons that the worst-case scenarios are so often played out.

None of the participants in a war of attrition, or a game of Chicken, has an interest in making the ultimate settlement more costly; but all of them want to shunt as much of the cost onto others as possible. The war goes on to the extent that the desire to come out ahead dominates the urge to compromise. What then might heighten the sense that winning is imperative, and weaken the feeling that compromise is desirable? Theory and experience point to four factors.[2]

The stakes. Higher stakes in contention give each side stronger reasons to fight to the finish, in order to avoid massive losses, or to realize massive gains. James Madison realized this, and in one of the more famous passages in the *Federalist Papers* argued that the way to mitigate crippling factional strife was to lower the stakes, and thus make it impossible for any faction to lose everything (or win everything).[3] In financial crises, both debtors and creditors have good reasons to fear being made destitute if they lose – the former because they will have to spend decades shouldering an impossible debt burden, the latter because they will lose a valuable asset and even risk insolvency. In some historical debt crises, indeed, the stakes were even higher: a losing debtor could lose its sovereignty. In the 1930s, those who lost the financial conflict faced dire economic results, and even physical danger, as when authoritarian nationalist regimes turned upon both foreign and domestic creditor classes. The higher the stakes, the greater the incentive to fight to the bitter end.

Uncertainty. Even if all groups in a crisis-ridden society were sure that the ultimate effects of a settlement would be positive, they could not be sure that they would end up on the winning side of the ledger that, of necessity, will include some losers. One party's insecurities about the implications of a settlement give it reasons to delay, whether to seek greater assurances or to cut a more favorable deal. The greater the uncertainty there is about the precise distribution of costs and benefits in an eventual crisis resolution, the stronger is the desire to delay agreement.

Lack of credibility. Most arrangements to resolve financial crises require that both sides make assurances about future behavior: debtors agree to service their debts, creditors promise to reopen lines of credit. But both sides have strong reasons to agree to comply in order to get a better deal, only to then go back on their words. This is not necessarily due to dishonesty, but by the complex forces jockeying for position on both sides. Creditor countries and institutions may disagree among themselves, while debtor nations are riven by factional conflict, and this can make commitments made in good faith impossible to keep a month, or a year, later. Knowing how tenuous are such promises, neither side may be willing to make valuable concessions. This was a central problem in the 1930s. In 1931, as the major Austrian Creditanstalt bank lurched toward a bankruptcy that everyone recognized would create serious Europe-wide problems, the European powers arrived at a joint rescue plan. However, this plan broke down in the days before the bank failed because the German and French sides did not trust each other to follow through on their promises. Where a settlement involves a promise of future compensation in return for compromise, the lack of credibility of such compensation is a grave impediment to compromise itself.

Lack of solidarity. Society as a whole bears a terrible cost for delaying a resolution to crisis. Yet "society" is a nebulous concept, and this cost may not be felt by all. Countries that are riven by ethnic, political, or other divisions will find it much harder to agree to make the sacrifices necessary in the present to preserve the future. Germans were willing to pay a stiff price for German unification; they are not willing to pay anything like as high a price for European unity.

All of these factors help explain the grave difficulties that countries have faced in resolving serious debt crises, and why Reinhart and Rogoff estimate that such crises take anywhere from five to ten years to resolve. The very high stakes involved, the grave uncertainties about the impact of a settlement, the difficulties in crafting agreements that are credible, and the absence of a sense of solidarity among the parties – all these stand in the way of a resolution that would, in the end, be in the general interest.

Lost decades, then, are the result of the political inability of debtors and creditors to arrive at a compromise that is in both sides' interest – at a Pareto improvement. On both sides of the Atlantic, in one way or the other, we appear to be at or near this predicament. So what does the experience of such wars of attrition past suggest of a positive nature? That is, what might we suggest that could smooth the path toward a happier outcome going forward?

Avoiding another lost decade

We can escape another lost decade, but it will not be easy. One reason, apart from all those mentioned, is that the global nature of the crisis means that a resolution will require international cooperation – and international cooperation is never simple.

Nonetheless, most of the problems our societies face will be difficult, even impossible – or at least very costly – to resolve by single national governments alone.

In this context, it is worthy of note that there is an impressive recent record of recent international cooperation, specifically on monetary policy. Almost as soon as the crisis broke, the world's major central banks began working together to limit the damage. The results have been encouraging, and surprising to many who felt that macroeconomic policy coordination was neither likely nor advisable. One can understand monetary policymakers taking a well-deserved rest on their laurels.

However, experience and common sense make clear that monetary policy cooperation is necessary, but not sufficient, to avoid a further descent. The interwar period, again, tells cautionary tales. From the vantage point of 1928, in fact, self-congratulations might have seemed in order. Starting in 1920, central bankers and other economic policymakers had engaged in an unprecedented range of cooperative ventures: conferences, treaties, the creation of international organizations. Central bankers, the League of Nations Economic and Financial Committee, and private bankers had overseen a challenging series of stabilization programs in Central and Eastern Europe, and in Latin America. Virtually every major economy was back on the gold standard. And yet the entire architecture of collaboration collapsed within a couple of years of the onset of the crisis. As it turned out, central bank cooperation could not overcome the broader and deeper political disagreements that erupted over the morass of sovereign and private debts that weighed down on the world economy after 1929. So cooperation that goes beyond the purely monetary is necessary; but of what sort, and to what end?

One could hope for international cooperation to avoid debt crises in the first place. This desire is reflected by ongoing discussions of the desirability of international macroeconomic cooperation, especially with respect to global imbalances. The sentiment underlying this trend is laudable, and is likely to develop further in coming years.[4] Nonetheless, it is highly unlikely that debt crises can definitively be prevented: we do not fully understand why they recur, and even if we did, avoiding them might involve undesirable limits on cross-border lending. So long as international lending persists, foreign debt crises will recur.

How, then, can we work to facilitate the resolution of those debt crises that do develop? We can start by addressing the factors that contribute to the eruption and prolongation of the wars of attrition in which so many debt crises have become mired. And so we revisit the four factors discussed above, but in reverse.

Stakes. Inasmuch as higher stakes feed intransigence, so can compromise be facilitated by making clear that all-or-nothing outcomes are off the table. If the parties are confident that the costs (and benefits) of a settlement will be relatively equally distributed, they have stronger reasons to arrive at a settlement. One way to diminish the stakes – common in most debt-ridden societies – is to allow a bit of inflation to reduce the real debt burden.[5]

Uncertainty. As insecurity about the results of a resolution leads to delay, greater information about its impact can make it easier to negotiate. Where both sides know what the results of possible settlements will be – and what the effect of not settling will be – they have less reason to stall in favor of a more certain outcome. This implies, contrary to much current thinking, that open and direct discussion of the terms of a debt restructuring is likely to lead to a more rapid resolution than one that is kept secret, and that keeps the public on both sides guessing.

Credibility. The eventual agreement will certainly require commitments about future behavior on all sides. Where these commitments can be believed, they will be more likely to be accepted. Third parties are a traditional way of trying to provide some modest assurance that promises will be kept.

Solidarity. It may be foolhardy to think that a sense of social solidarity can be created. However, some political institutions and arrangements are more encompassing than others, and lead policymakers – and perhaps the public – to think beyond narrow interests. Governments of national unity, for example, can cut across partisan and other divisions to allow consideration of the broader society-wide effects of the successful resolution of a crisis. So too can broad coalitions that include otherwise conflicting sides of the battlefield.

Many of these approaches have emerged over time in attempts to resolve debt crises. In the nineteenth and early twentieth centuries, joint private-public creditor committees were the principal locus of negotiation. In the interwar period, the League of Nations Economic and Financial Committee came to play a major role. Since the 1970s, most debt-crisis management has been overseen by the International Monetary Fund. These auspices have helped, in the ways indicated, make agreements easier – with varying degrees of success. They can make available accurate information about the implications of a settlement, as well as provide a third party to help make any promises more credible. All this can allow the opposing sides to ratchet down their demands and come to a more rapid, more equitable resolution.

Perhaps the most striking example of what can go wrong, and right, in these circumstances comes from comparing the policies of the United States in the aftermath of World Wars One and Two. In the 1920s and early 1930s, the United States took an intransigent position on war debts, and by extension reparations – as Calvin Coolidge said, "They hired the money, didn't they?" The Americans, with Congress dominated by isolationists who wanted little to do with European entanglements, adamantly refused to consider renegotiating debts until it was much too late. The Allies generally kept the financial burden placed on Germany as reparations payments very ambiguous, so much so that even today there is uncertainty as to how large they were expected to be. Some of the major creditors made extreme demands on the debtors, and showed no willingness to provide relief as needed. And the highly polarized political situation in both debtors and creditors meant that any commitments made were likely to be violated by a successor government. All this was, as we know, a formula for stalemate, and eventually disaster.

After World War Two, the United States took a very different path – perhaps because it had learned lessons, perhaps because American politics had evolved. The United States largely forgave war debts and forwent reparations. It oversaw a remaking of entire political systems to lower the stakes of political conflict, encouraging an encompassing centrist consensus around Western Europe. The U. S. government, especially in the context of the Marshall Plan, acted as intermediary among previously warring nations to provide clear commitments of future behavior. All this made it far easier to work out the economic adjustments necessary to rebuild Western Europe.

More recent experiences incorporate similar lessons. IMF programs typically insist on some sharing of burdens between debtors and creditors, the Fund's involvement enhances the credibility of commitments on both sides, and the IMF's economic analysis and information help define the likely implications of agreements made. Often, the involvement of foreign governments provides similar anchors to speed a settlement. And as negotiations proceed, it is important to point out that creditors can often make things better *for themselves* by compromising than by remaining intransigent. An earlier, comprehensive, credible settlement is better than a delayed, fragmented one that can easily be evaded or disavowed.

To be sure, there are no magic potions to speed the resolution of a debt crisis. The interests in play are too significant, and the potential costs too high, to be readily amenable to some easy answer. Nonetheless, theory and history provide some suggestions about tactics to pursue.

The path ahead

What is certain is that we face grave problems as we attempt to resolve our ongoing debt crises. It is easy to identify the obstacles; it is not easy to identify politically feasible ways forward. But we do need to find some way to lessen the intransigence, lower the rhetoric, improve the information available, provide credible commitments to the protagonists – and to have all involved take into account the broader costs of inflexibility and delay.

All debt crises are extremely difficult, and many of them have led to a lost decade, or two. We are certainly at serious risk of repeating this experience. As we wrote in *Lost Decades:*

> A skeptic might conclude that nothing can change for the better, that neither the interest groups nor the taxpayers nor the policymakers have any reason to act differently. We prefer to think that there are times when citizens, voters, interest groups, and policymakers are able to rise above their own self-

interested concerns. We hope that now is one of those times; and that we learn from this painful episode to avoid another lost decade.

Notes

[1] Carmen Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (New York: Princeton University Press, 2009).

[2] The classic references are to Alberto Alesina and Allan Drazen, "Why are Stabilizations Delayed?" *American Economic Review* 81, No. 5 (Dec. 1991), pp. 1170-1188; and Raquel Fernandez and Dani Rodrik, "Resistance to Reform: Status Quo Bias in the Presence of Individual- Specific Uncertainty," *American Economic Review* 81, No. 5 (Dec. 1991), pp. 1146-1155.

[3] *The Federalist* No. 51; some earlier indications of these ideas are also in *The Federalist* No. 10.

[4] Jeffry Frieden, Michael Pettis, Dani Rodrik, and Ernesto Zedillo, *After the Fall: The Future of Global Cooperation* Geneva Report 14 (London: Center for Economic Policy Research, 2012).

[5] See, for example, Menzie Chinn and Jeffry Frieden, "How to Save the Global Economy: Whip Up Inflation. Now." *Foreign Policy* January 2012; and Menzie Chinn and Jeffry Frieden, "Better Living Through Inflation," *Milken Institute Review* Third Quarter 2012.