5 "Seven Lean Years" Revisited

The idea behind "seven lean years" is that it is unrealistic to expect to overcome the several problems facing most developed countries, including the U.S., in fewer than several years. The purpose of this section is to review the negatives that are likely to hamper the global developed economy, especially from the viewpoint of how much time may be involved.

First, one of the causes of the financial crisis was the over-indebtedness of consumers in certain countries, including the U.S., the U.K., and several European countries. As of today, although they have stopped increasing consumer debt – which itself is unprecedented and has eaten into consumption – the total improvement in personal debt levels is still minimal. It would take at least seven years of steady reduction to reach a more normal level. Anything more rapid than this would make it nearly impossible for the economy to grow anywhere near its normal rate or, perhaps, at all.

There is in the situation today a nerve-wracking creative tension. At one extreme, massive stimulus induces government debt to rise to levels that cause a real problem in servicing the debt – interest and repayment – or at least a crisis of confidence. At the other extreme, a draconian attempt to hold debt levels while the economy is still fragile runs the risk of causing a severe secondary economic decline. Deciding which horn of this dilemma to favor will probably prove to be the central economic policy choice of our time. I am sympathetic to those in power. This is not an easy choice. My guess, though, is that the best course is less debt reduction now and a longer, slower reduction later. Overdoing it now may well cause an economic setback for an already tender and vulnerable global economy that might easily be enough to more than undo all of the benefits of debt reduction. Indeed, with a weaker economy leading to lower government income, it might sadly cause debt levels to rise after all. This need for time to cure all ills is one reason why I picked a seven-lean-year recovery over a more normal and rapid one. The bad news, though, is that in the end, by hook or by crook, debt levels must be lowered at every level, especially governmental. There is almost no way that this process will be pleasant or quick.

Second, and the most immediately frightening aspect of the seven-lean-year scenario, is that although the credit crisis was caused by too much credit on too sloppy a basis, the cure was to increase aggregate debt by flooding economies with government debt. <u>Dangerously excessive financial system debt was moved across, with additions, to become dangerously excessive government debt</u>, with levels of debt to GDP not seen outside of major wars, and seldom then. <u>Increasingly the "cure" seems more like a stay of execution</u>. With bank crises, there is the backstop of the central government. For minor countries, the IMF <u>may</u> be a net help, but for major countries in trouble, the IMF seems outgunned and, if several major countries have a debt crisis simultaneously, the IMF is clearly irrelevant.

Third, we have lost a series of artificial stimuli that came out of the steady increases in debt levels and the related asset bubbles. For example, the artificial lift to consumers' attitudes resulting from steadily rising house prices is unlikely to return soon. In fact, some further price decline in house prices in the U.S. is probably more than a 50/50 bet, and in the U.K. and Australia is nearly certain. For sure, that feeling of supreme confidence – counting on the inevitability of further steady rises in house prices, which was baked into average U.S. opinion by 2006 (including Bernanke's, unfortunately) – is long gone. The direct shot in the arm to the economy from the rise in economic activity from an abnormally high rate of home construction and the services associated with an abnormally high turnover rate of existing houses (more realtors, etc.) is also a distant memory here. So the stimulus from rising prices has gone, and stock prices, although they have made a strong recovery everywhere in the developed world, are still way down from their highs of 10 years ago and, notably in the U.S., are <u>still overpriced</u>. Both the market and house price declines have also reduced confidence in the nest eggs that people felt they could count on for retirement as well as a little more spending on the way there. Now consumers are readjusting to a greater need to save and, perhaps unfortunately, a greater need to work longer. Unprecedentedly, they are paying down some consumer debt. These changed attitudes will surely last for years.

Fourth, although the financial system has passed its point of maximum stress in the U.S., very bad things may lie ahead in Europe. And the leverage in the system and the chances of further write-downs (yet more housing defaults and private equity write-downs, for example) leave banks undercapitalized and reluctant to lend. Any more shoes dropping here or in Europe, or elsewhere for that matter, will tend to keep them nervous. The growth in the total U.S. GDP caused by previous rapid increases in the size of the financial sector has also disappeared, and with any luck will stay disappeared, for it was not healthy growth in my opinion.

Fifth, the runaway costs in the public sector, particularly at the state and city levels, where average salaries and pensions ran far above private sector equivalents in a mere 15 years (why, that would make a good report by itself!), have run into a brick wall of reduced taxes. State and other municipalities are incredibly dependent on real estate taxes, which are down over 30% from falling real estate prices and defaults, and also on capital gains rates, which have been hit by falling asset prices generally. Their legal need to stay balanced is leading to painful cost cutting, which in turn puts pressure on an economy that is coming to the end of much of the stimulus. With many of the artificial stimuli of the '90s and 2000s gone, their revenues are unlikely to bounce back in one or two years, and a double-dip in the economy or new asset price declines would move their recovery back further.

Sixth, unemployment is high and will also suffer from the loss of those kickers related to asset bubbles. The U.S. economy appears to have an oddly hard time producing enough jobs to get ahead of the natural yearly increases in the workforce. (At least for a while, one long-term economic drag – slowing longer-term growth of the U.S. labor force – becomes an intermediate-term help in reducing unemployment, but beyond five years, it too will work to reduce GDP growth, as it has already done in the last 10 years.) Needless to say, unemployment works to keep consumer confidence and, hence, corporate willingness to invest, below normal.

Seventh, another longer-term problem for the global economy is trade imbalances. The U.S. in particular cannot continue to run large trade imbalances. In a world growing nervous about the quality of sovereign debt – even that of the U.S. – domestic sovereign debt levels have exploded. The added complication and threat to the dollar from accumulating foreign debts just adds risk and doubts to the system. This is similar to the accumulating surpluses of the Chinese. Imbalances destabilize the system. The trick, though, is to reduce these imbalances so that the process does not reduce global growth. This necessary rebalancing will not be quick or easy.

Eighth, there is a related but different problem with the euro: incompetent management in Spain, Greece, Portugal, Ireland, and Italy allowed the local competitiveness of their manufactured goods to become 20% or more uncompetitive with those of Germany. It was never going to be an easy matter to head this process off, and doing so would have taken some tough actions with uncomfortable short-term consequences. But they could see the problem building up like clockwork at about 2% to 3% a year, year after year. This did not result from the banking crisis, and it was never going to be easy to solve with a fixed currency. The difficulty was implicit in the structure of the euro from the beginning. Indeed, my friend and former partner, Paul Woolley,* believed, and let everyone know it, that from day one this was a fatal flaw nearly certain to bring the euro down under stress. But one might have hoped for better evasive action or better survival instincts.

Greece in particular has two largely independent problems. First, it has approximately 22% overpriced labor (complete with 14 months' salary and retirement in one's 50s), which can only be cured by reducing their pay by 22%. This would be tough for any government that does not have an exceptionally well-established social contract – a commitment from individuals that they have obligations to help the whole society to prosper or, in this case, muddle through. The Greeks probably do not have it. Perhaps the U.S. does not either. Would we take being told that ordinary workers would have to earn 22% less when there are so many other people to blame for our current problems? The Japanese, in contrast, probably do, but may well have other offsetting disadvantages.

The second problem for the Greeks is that they have accumulated too many government debts relative to their ability to pay and, as the doubts rise, so do the rates they must pay such that their ability to pay falls and the doubts rise further. Temporary bailouts are postponements of a necessary restructuring. Should the system get out of control, there is the problem of the Greek debt that is stuffed into other European banks. (My colleague, Edward Chancellor, is writing on this topic.) I merely want to make the point that these twin Greek problems, which affect, to varying

* Paul Woolley started a center for the study of "Capital Market Dysfunctionality" at the London School of Economics.

intensity, the other PIGS, have become an intrinsic part of the "seven lean years," more or less guaranteeing slower than normal GDP growth and a long workout period.

Ninth, the general rising levels of sovereign debt and the particular problems facing the euro bloc and Japan are leading to the systematic loss of confidence in our faith-based currencies. It is becoming a fragile system that will increasingly limit governments' choices in terms of dealing with low growth and excessive credit.

Finally, and possibly most important of all, on a long horizon there is a very long-term problem that will overlap with the seven-year workout and make the period even tougher: widespread over-commitments to pensions and health benefits.