theirview

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How to prevent a Great Depression

Exiting the euro zone and currency devaluation may be the only solution for peripheral economies such as Greece

BLOOMBERG

The latest economic data suggests that recession is returning to most advanced economies, with financial markets now reaching levels of stress unseen since the collapse of Lehman Brothers in 2008. The risks of a crisis even worse than the previous one are significant. So, what can be done to minimize the fallout of another economic contraction and prevent a deeper depression and financial meltdown?

First, we must accept that austerity measures, necessary to avoid a fiscal train wreck, have recessionary effects on output. So, if countries in the euro zone's periphery are forced to undertake fiscal austerity, those able to provide short-term stimulus should do so and postpone their own austerity efforts. These countries include the US, Britain, Germany, the core of the euro zone, and Japan.

Second, while monetary policy has limited impact when the problems are excessive debt and insolvency rather than illiquidity, credit easing, rather than just quantitative easing, can be helpful. The European Central Bank should reverse its mistaken decision to raise interest rates. More monetary and credit easing is also required for the US Federal Reserve, the Bank of Japan, the Bank of England, and the Swiss National Bank. Inflation will soon be the last problem that central banks will fear, as renewed slack in goods, labour, real estate, and commodity markets feeds disinflationary pressures.

Third, to restore credit growth, euro zone banks and banking systems that are under-capitalized should be strengthened with public financing in a European Union (EU)-wide programme. To avoid an additional credit crunch as banks deleverage, banks should be given some short-term forbearance on capital and liquidity requirements. Also, since the US and EU financial systems remain unlikely to provide credit to small and medium-size enterprises, direct government provision of credit is essential.

Fourth, large-scale liquidity provision for solvent governments is necessary to avoid a spike in spreads and loss of market access that would turn illiquidity into insolvency. Even with policy changes, it takes time for governments to restore their credibility. Until then, markets will keep pressure on sovereign spreads, making a self-fulfilling crisis likely.

Fifth, debt burdens that cannot be eased by growth savings or inflation must be rendered sustainable by orderly debt restructuring, debt reduction and conversion of debt into equity. This needs to be carried out for insolvent governments, households, and financial institutions alike.

Sixth, even if Greece and other peripheral euro zone countries are given significant debt relief, economic growth will not resume until competitiveness is restored. And, without a rapid return to growth, more defaults cannot be avoided.

There are three options for restoring competitiveness within the euro zone, all requiring a real depreciation —and none of which is viable:

- A sharp weakening of the euro towards parity with US dollar, which is unlikely, as the US is weak, too.
- A rapid reduction in unit labour costs, via acceleration of structural reform and productivity growth relative to wage growth, is also unlikely, as that process took 15 years to restore competitiveness to Germany.
- A five-year cumulative 30% deflation in prices and wages—in Greece, for example—which would mean five years of deepening and socially unacceptable depression; even if feasible, this amount of deflation would exacerbate insolvency, given a 30% increase in the real value of debt.

Because these options can't work, the sole alternative is an exit from the euro zone by Greece and some other current members. Only a return to a national currency—and a sharp depreciation of that currency—can restore competitiveness and growth.

Leaving the common currency would, of course, threaten collateral damage for the exiting country and raise the risk of contagion for other weak euro zone members. The balance-sheet effects on euro debts caused by depreciation of the new national currency would thus have to be handled through an orderly and negotiated conversion of euro liabilities into the new national currencies. Appropriate use of official resources, including for recapitalization of euro zone banks, would be needed to limit collateral damage and contagion.

Seventh, the reasons for advanced economies' high unemployment and anemic growth are structural, including the rise of competitive emerging markets. The appropriate response to such massive changes is not protectionism. Instead, advanced economies need a medium-term plan to restore competitiveness and jobs via new investments in high-quality education, job training and human-capital improvements, infrastructure, and alternative/renewable energy.

Eighth, emerging-market economies have more policy tools left than advanced economies do, and they should ease monetary and fiscal policy. The International Monetary Fund and the World Bank can serve as lender of last resort to emerging markets at risk of losing market access, conditional on appropriate policy reforms. And countries, such as China, that rely excessively on net exports for growth should accelerate reforms, including more rapid currency appreciation, in order to boost domestic demand and consumption.

The risks ahead are not just of a mild double-dip recession, but of a severe contraction that could turn into Great Depression II. Wrongheaded policies during the first Great Depression led to trade and currency wars, disorderly debt defaults, deflation, rising inequalities, poverty, desperation, and social and political instability that eventually led to the rise of authoritarian regimes and World War II. The best way to avoid the risk of repeating such a sequence is bold global policy action now.

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otherviews

BORDERLINE

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Betrayal across the Durand Line

It is rare in the annals of history for countries purportedly allied with each other also to be at war against each other. The alliance between the US and its Western allies with the Soviet Union during the Second World War (WWII) was one such instance. The US-Pakistan cooperation in the so-called war against terror is another example. In both cases the allies regularly assaulted each other even as they fought against a common enemy.

In the first instance Winston Churchill eloquently and scathingly summed up the predicament of the alliance with Moscow when Nazi Germany invaded the Soviet Union in 1941 thus: "If Hitler invaded Hell I would make at least a favourable reference to the devil in the House of Commons." Subsequently in 1946, just months after the war, Churchill again dramatically observed that "an iron curtain has descended across the Continent" and warned of a Cold War with the Soviet Union.

While top US officials, including the outgoing chairman of the Joint Chiefs of Staff, Admiral Mike Mullen, have not been as oratorical or succinct as Churchill, their comments convey the same quandary over Pakistan. Over the past year alone, attacks led by the Sirajuddin Haqqani network, including on the Inter-Continental Hotel in Kabul, a truck bomb that killed several Afghans and injured over 70 US soldiers, and the brazen assault on the US embassy in Kabul, compelled Mullen to publicly admit that not only is the Haqqani network "a strategic arm of Pakistan's Inter-Services Intelligence [ISI] agency" but that these attacks were probably carried out at the behest of the ISI, the ostensible ally of Washington. Other revelations of deadly attacks by Pakistani troops on their US counterparts in 2007 in Teri Mangal have only strengthened the conviction that the ally may be more dangerous than the common enemy they are fighting.

However, unlike the WWII experience, the current relationship with a nuclear-armed Pakistan poses greater complications for the US. First, while there was a definite end to WWII, which enabled the US (and the West) to brand the Soviet Union as an enemy, the absence of a neat conclusion to the war against terrorism and the dependency on Pakistan to conduct it means the US may never be able to condemn its reluctant ally as an enemy. This is evident from the pussy-footing in Washington around even the decision to declare the Haqqani network as a terrorist organization.

Second, after WWII the US was able to use the Marshall Plan to wrest at least two allies—Greece and Italy—away from the lure of communism and, possibly, the Soviets. However, similar efforts by the bold Kerry-Lugar-Berman plan and other US aid to wean Islamabad from its unsavoury friends have come to naught. ("Throwing good money after a bad cause", *Mint*, 3 November 2009).

This is because Pakistan is not a normal state. The primary reason is the very nature of its polity, particularly the omnipotent security establishment, which has monopoly over the decision-making process even when it is ostensibly accountable to the democratically elected civilian government. Thus, to retain unfettered power, the security establishment will inevitably put its own survival over even that of the state of Pakistan. As noted Pakistani scholar S. Akbar Zaidi cautioned, "US aid to Pakistan's military has only strengthened Pakistan's military instead of strengthening its weak, fledgling, but emerging, democracy."

At stake is the very survival of Pakistan and its evolution into a normal state where the security apparatus serves the interests of the state and not the other way around. This is only possible if Washington has the courage to stop sleeping with the enemy. Otherwise, the spectre of a failed state armed with nuclear weapons will continue to haunt the world.

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