A Tragic Opera in Three Acts

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Crises unroll like a tragic opera, with different schools of thought in mortal combat. We have reached the first scene of the third act. Yet things are never over until the fat lady sings – even if the forces of destiny seem irrepressible. Who will win – The heterodox or the orthodox school? Expect the answer in 2012.

Act I. Those who believed it was just a passing crisis reached out for the traditional remedies of Keynesian economic policy: re-boot consumption by raising public and social expenditure, and allow deficits to run amok. We could have added in devaluation, a cheap way to increase competitiveness, just as we did in the old days. This magic potion would lead to growth, shrinking unemployment, and plenty of tax revenues to pay off the deficit - Hey presto! But suddenly, the trusty old macroeconomic recipe, extracted from the dog-eared pile in the history store, has turned sour. State expenditure did indeed increase, the deficit did indeed run out of control…. And now the economy has taken a double dive. Instead of the hoped-for return to growth, there is going to be stagnation or even recession. What went wrong?

Act II. It was not a passing crisis, but a structural one. By applying an unsuitable therapy designed for a closed economy, we have triggered numerous, persistently perverse effects: a spectacular trade imbalance – by stimulating domestic consumption we caused imports to soar – an exploding deficit, a crippling public debt, and increased refinancing costs. As it happens, the rating agencies have expressed doubt about our sovereign signature. We should have anticipated this, but we believed so strongly in the economic alchemy that we turned a blind eye. The result? We must now rush to stem the public deficit and curb ballooning expenditure. We are increasing taxes, which will slow down activity and the speed at which the deficit shrinks. Sooner or later, there will be a hike in interest rates, which will increase the cost of the debt and slow down budget adjustment. As for cutting social and public spending – you must be joking! Come on, we’re in a crisis! The increase in taxes of every kind means that we are less and less competitive, so that means that the other asthmatic engine supposed to drive growth – exports – will slow down too. Oops, we forgot that we belong to a monetary area and the exchange rate is unchanging. Oh, dear, what a pity.
Act III. Eureka! The solution is to monetise the massive public debt accumulated over all these years. If the central bank buys up all the public securities and places them in its balance sheet, then there will no longer be a deficit problem since its re-financing will be cheap. Plus, we avoid the markets that demand risk premiums because of our downgraded signature. Elementary, my dear Watson! That way, we can continue to splash money around without having to struggle to make structural reforms. The same people that yesterday called for a deficit to solve the crisis, and before that for a shorter working week to solve the problem of unemployment, are now shrieking out for monetisation of the debt – henceforth dubbed as the “unorthodox monetary policy”. It sounds better than “heterodox monetary policy”.

Entering public debt, the quality of which is deteriorating, into the issuing bank’s balance sheet would jeopardise its solvency, because its balance sheet would increase and its ratios deteriorate. Ultimately, of course, it would create a risk of inflation. If money is printed wholesale, and counterbalanced by public debt securities, it will sooner or later lead to inflation. And here we have it: heterodox monetary policy implies that inflation is “benign neglect”. Let us devalue all debts, let us repay them in melting money, let us despoil investors and savers. Rather than cut deficits and public and social expenditure, rather than foster saving and investment to prepare for the future and restore competitiveness, let us allow sly, invisible inflation to tax us all indiscriminately. As Keynes advised, let us practise “euthanasia of the rentiers”, who naively trusted the State and stupidly invested in treasury bonds. That would be the final scene of Act III …

We are back to our old French bêtes noires (that Germany will have nothing to do with, for historical reasons). Finally, there has been no decision in the debate between the heterodox and orthodox schools, the laxists and the rigorists. It is fortunate that the Maastricht Treaty provided for an independent European Central Bank. It has made it much more difficult for today’s “princes” to snip away at the currency.