2012 : Suspicion, mistrust…confidence?

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2012 looks set to be the pivotal year in the economic and financial crisis currently afflicting developed countries. Current sentiment is dominated by uncertainty over major questions like the solution to the eurozone debt crisis, the sustainability of US growth and the ability of emerging economies to operate independently of the developed zone.

The impact of political leadership

Political leaders were mainly responsible for the 2011 slump in risk assets, particularly in the eurozone. Strategists and investors underestimated how quickly the situation was worsening because they had put too much trust in the capacity of heads of government to deal with the problems and to do so in a way that matched the market's speed of reaction. But government inefficiency, already on show in the management of Greece's excessive debt mountain, actually forced the ECB to stick with a conventional monetary stance for far too long. The bank even proceeded with a rate rise in July. The situation was similar in the US where the failure of Congress to agree on a debt ceiling and the psychodrama that led up to its eventual raising caused rating agencies to downgrade the US credit rating. That caused a sell-off on markets that was amplified by high frequency trading.

A rational mind might conclude that 2012 has started amid such widely held pessimism, suspicion and even aversion that markets have already factored in the worst case scenarios and that any surprises could only be positive.

And yet if 2011 taught us anything, it is that it pays to tread cautiously when political leaders are in charge of finding solutions.

It is tricky to make economic forecasts but well nigh impossible to predict political decisions.

Conflicting ideas and the debt wall

There is currently a very lively debate between supporters of the Austrian School and Keynesians or neo-Keynesians. The former believe in pain for gain however unpleasant: sorting our imbalances necessarily entails difficulties if the economy is to start afresh on secure foundations and return to growth. Liabilities need to be cleaned up. In any case, there is really no option as governments cannot take on more debt.

For Keynesians, governments need to support and stimulate the economy during slowdowns. But they must be careful to build up surpluses when the economy is growing. The problem is that for close to 40 years, governments have maintained deficits even during periods of robust economic growth. Worse, massive stimulus programmes since 2007 have led to excessive debt accumulation and in many countries including the eurozone, there is no sign of the trend reversing.

We can estimate the maximum height of the debt wall and its consequences for households -as in the US in 2007- but the exercise is trickier for governments. This is because countries can continue taking on debt as long as their creditors remain confident. This has led to the paradoxical situation where the US, Japan and the UK have been able to push back the debt wall even though they have higher debt levels than eurozone countries. The US did this through growth, the UK sacrificed its currency and nationalised banks and Japan simply mopped up domestic private savings. The eurozone has none of these options as it has no growth, cannot monetise its debt at the expense of its currency and has no steady supply of willing domestic lenders. The eurozone has no unity; on the contrary it is the result of welding together very different economies with insufficient governance.

This makes the problem political and the only solution is to restore confidence; if the government cannot act as Keynesians would wish, other economic agents can. Hence Neo-Keynesianism.

Rebuilding confidence in the eurozone

If governments cannot stimulate the economy because they are viewed as shouldering too much debt, then it is up to the other economic agents to step in (unless, of course, one subscribes to the Austrian School of thinking). But although households have low debt levels and companies are in sound financial health, they face the hurdle of government austerity drives and action from regulators. To reduce deficits, governments are tempted to raise taxes while cutting spending. That hits household confidence and purchasing power and therefore consumers. Meanwhile, in an attempt to ward off any fresh financial crisis, regulators force prudential rules on the financial sector and even speed up their deployment. Inevitably, this hits lending to the economy and therefore companies. Concerns over slowing consumption and a cautious attitude to borrowing -because of the financing risks- leads companies to reduce costs and postpone investments.

All this results in a recessionary spiral with the possible consequence of aggravating the sovereign debt crisis.

From the neo-Keynesian point of view, this spiral has to be broken and that necessarily involves political decisions. Over the short term, central bank action is required to avoid the devastating effects of deflation and the liquidity trap.

Looking further out, they have to introduce clear political and budgetary policies and structural measures to support and galvanise the sort of economic agents who are capable of generating growth. Individuals need to be encouraged to put their savings to productive use rather than adding to them. Banks need to have sufficient liquidity at their disposal and must be coaxed into lending to the private and public sector rather than leaving cash on deposit with central banks. Companies should be prompted and helped to invest and create jobs.

So far, our political leaders have done too little, too late even if recent policy decisions are a step in the right direction. Instead of focusing on wealth preservation to the exclusion of anything else, investors should be ready to snap up stocks trading at irrational valuations. But that will depend on our political leaders restoring confidence with actions rather than words. And they will have to move quickly.

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