Interview with Richard Koo, Chief Economist, Nomura Research Institute

Traditional Economic Theory Not Working Anymore in Today's Volatile Economy

By *Japan SPOTLIGHT*

Richard Koo has developed a number of theories and policy recommendations which are relevant to current developments in the economy. One such contribution to economic analysis is his definition of Japan's "lost decade" – the long recession during the 1990s – as "a balance sheet recession". He explains this new perspective in looking at current economic trends in this interview with *Japan SPOTLIGHT* in which we explored his ideas and thoughts about the volatile global economy.

Fiscal Policy More Effective than Monetary Policy

JS: Please could you explain the idea that labor market situations can tell us about the stages of economic development?

Koo: Countries go through a number of stages in economic development. The first, when you are industrializing, all the workers are in the countryside and when they move to the city their wages don't increase that much because there are so many excess workers. At that stage the capitalists gain all the benefits. The workers get very little. Then when all the excess workers are absorbed into the cities, wages start to go up. The workers start to get bargaining power for the first time. Capitalists still want to invest; but that increases the wage share so domestic demand increases as well. Companies are forced to take two actions. Wages are rising so you have to increase productivity but at the same time aggregate demand is also increasing because the workers are paid more. This means they have to increase capacity as well. So in order to meet these two demands you have to do a lot of capital investments. This is what I call the "Golden Era" because everyone benefits. At that point monetary policy works very well because there's a very strong demand for funds from the private sector.

But at some point, wages reach a level where foreign competition comes into the picture. At that point companies stop investing as much at home and start investing more overseas. This is what I call the "pursued phase" of the economy. Wages stop rising or only rise very slowly. Imports come in in massive fashion. Consumers faced with slow wage growth have to become a lot more careful. In that world, monetary policy is not as effective as before. All advanced countries today are in this position: the pursued phase. Once you understand that you can understand why interest rates are so low. People are still saving. But in the Golden Era businesses were willing to borrow and that helps the economy to move forward. Once you enter the pursued phase, people are still saving but the borrowers may be not so large in number because businesses would rather invest outside. In that case the government may have to do more fiscal policy to keep the economy going. So the importance of monetary and fiscal policies switch after this point. We are all biased towards thinking that monetary policy is important, that we have to fight inflation, that there must be strong demand for funds, and that interest rates must be relatively high. But actually we are not in that world anymore.

Richard Koo, Chief Economist, Nomura Research Institute

JS: So in your view, monetary policy doesn't work well in the pursued phase.

Koo: During the Golden Era so many people want to invest in so many things, so demand for funds is always there. Workers are paid more so there's huge demand for consumption as well. Naturally this is all very inflationary. So the central bank has to do all it can to keep inflation under control. The 2% inflation target, which so many countries around the world have adopted, was actually devised

during this period. The point is, as soon as inflation starts to go above 2% the central bank will start acting pre-emptively instead of waiting while inflation gets out of control, and then you try to contain it. We're still operating with that rule even though we are not in that era anymore. I think that needs to be looked at more carefully.

JS: So you favor fiscal policy to create demand?

Koo: That's the fundamental point, because your question started with the labor market. When wages are not rising, creating demand is already a challenge in itself. On top of that, we had a bubble bursting. Millions of balance sheets are under water. Then people have to pay down debt. But in a national economy if someone is saving money, which includes paying down debt, someone else had better borrow money to keep the economy going. In a normal world, if there are too many borrowers, interest rates are raised; too few borrowers, interest rates are lowered to make sure the income cycle is maintained. But once every several decades when we enter this world of balance sheet recession, you bring rates down to zero and there are still no borrowers. Everybody is paying down debt. In that world governments have to borrow money to keep the economy going. If governments refuse to borrow money then the economy goes into a deflationary spiral because all the money that comes into the financial sector will not be able to leave. That's what Japan proved from 1990 onwards: once you are in this type of recession, the government has to act as a borrower of last resort to keep the economy going.

Assessment of G20

JS: Given what you've said, how do you assess the latest G20 agreement supporting a flexible fiscal policy?

Koo: I'm very happy the G20 is finally coming back to reality again. There was an emergency G20 meeting held in Washington DC in November 2008, two months after the Lehman crisis. At that time all the G20 countries agreed to a fiscal stimulus to keep the economy from collapsing. But in just two years, in Toronto in 2010, all this orthodoxy came back again and shot that agreement down and the G20 agreed to cut the deficit in half. The 2010 Toronto Summit was like putting the world economy in reverse. Europe got into huge problems as a result. Ben Bernanke of the Federal Reserve said we cannot cut the deficit now. He used the term "fiscal cliff" — we cannot afford to fall off the fiscal cliff — because he understood there was no one in the United States borrowing money at that time. The private sector was saving close to 10% of GDP at zero interest rates. Janet Yellen said the same. In Japan we had Finance Minister Taro Aso who argued for putting in arrow two of Abenomics, which is fiscal stimulus also. So those who realized the Toronto Summit was a mistake did relatively well, but those who followed that path, like the Europeans, did very poorly. I think it's a good thing now that the G20 is coming back and saying we do need a more flexible fiscal policy. They've tried monetary policy for eight years now. They all have 2% inflation targets which they all failed to achieve, so it's about time they went back to the drawing board.

Possible Impediments to Fiscal Policy

JS: Two points. The EU needs to maintain economic integration, which might be a constraint on flexible fiscal policy. In Japan we're moving towards an ageing society so we will need more social welfare expenditure and that might mean a more restrictive budgetary policy.

Koo: On your first point, I think I am one of the very few people who predicted the euro crisis and the way it unfolded. In my 2003 book *Balance Sheet Recession*, I clearly stated that if the EU falls into balance sheet recession, when the debt-financed asset price bubble collapses, then it should remove the 3% deficit to GDP rule right away to be able to handle it. But the Europeans kept the rule and look at where they are now. Look at some of the numbers — private sector in Spain saving 7% of GDP, Irish private sector saving 12% of GDP at negative interest rates. If the private sector is saving 7% but the government can only borrow 3% of GDP, what happens to the remaining 4%? It comes into the financial sector but it won't be able to leave because there are no borrowers and that becomes a deflationary gap in the economy. The Maastricht Treaty as it is written is defective because it cannot handle balance sheet recession. In 1998 when the treaty was ratified no one outside of Japan knew anything about balance sheet recession. It was never taught in universities. No one thought the private sector would be saving 7% at zero interest rates; they should be borrowing 7% at zero. But now we have the opposite situation. So I am suggesting they should add one more line to the Maastricht Treaty and that line should read that if the private sector of a country is saving more than 3% of GDP at zero interest rates, then the government should be allowed to borrow more than 3% of GDP in order to stabilize the economy. It has to be zero interest rates, first. If at zero interest rates the private sector is saving more than 3% of GDP they are certified to be in balance sheet recession and therefore government should be allowed to borrow more than 3%.

There is one other European issue that needs to be taken care of. Outside of the eurozone, once you fall into this type of recession, government bond yields come down to ridiculously low levels. It's a

natural reaction to the balance sheet recession in that there are hundreds of fund managers who handle government pension money, social security, life insurance who cannot take too much foreign exchange risk, who cannot put all the money in stocks — they have to have fixed income assets. Suppose you are one of those investors and the economy is in balance sheet recession where the private sector is not borrowing money. If you have already exhausted your foreign exchange exposure limits and your equity holdings limits, then the only assets you can buy are the government bonds. That's why bond yields come down to these ridiculously low levels during balance sheet recessions, which is the market's way of telling the government that this is time to increase not cut the deficit.

But in the eurozone this mechanism doesn't work very well. Why is that? If you're a Japanese fund manager and you're in balance sheet recession, you have to buy JGBs, if you're a US fund manager you have to buy US Treasuries, if you're in the UK you have to buy Gilts. But if you're a Spanish fund manager, do you have to buy Spanish government bonds? The answer is no. You can buy German government bonds or Dutch government bonds, because they are all in the same currency zone. So the foreign exchange exposure limits that ring-fence government bond markets in other countries don't work in the eurozone because there are 19 government bond markets within the same currency zone. So we need something additional. I suggest introducing different risk weights. If you buy your own government bonds the risk weight will be still low but if you hold someone else's government bonds the risk weight will be higher on the understanding that you know your own government bond market best. That way you encourage Spanish savings to go to the Spanish government bond market, Irish savings to go to the Irish government bond market and then this mechanism will start working. Bond yields will come down, the government can spend that money and those economies will recover. So these are the measures needed.

On Japan, of course the ageing society is a huge worry. But there are factors that could make Japan work better that we could put into actual practice. For example, inheritance tax in this country is extremely harmful for economic growth. So many successful people in this country are talking about moving money abroad to avoid inheritance tax. These are successful people who actually created businesses, increased employment, increased economic growth. But because of the 2015 hike in inheritance tax they are using their best brains at the most important time of their lives to get around it. As a result, real estate is booming in this country even though the population is shrinking. It makes no sense. We are wasting precious resources and entrepreneurial talent. There are so many areas like this where we could make improvements so that the resources we do have — they may be shrinking — could be put to good use and that's where the growth will come from. Taiwan cut inheritance tax to 10% in 2008 and the tax revenue did not fall. That's the kind of situation this country should shoot for.

Innovation Toward Golden Era

JS: Some say that we are facing a post-industrial revolution and an era of high private investment thanks to this data-driven revolution. If that happens, will there be a return to inflation?

Koo: If there's some technological breakthrough and suddenly companies have to make lots of investments to meet requirements that didn't exist before, then we could move back to the Golden Era in that suddenly there will be a strong demand for funds, monetary policy will start working again and fiscal policy will have to be cut. That could happen. The driverless car could be one of those big changes. Because if that becomes the new industry standard, so many things will have to be changed in the streets, in the cars themselves and so forth. That could potentially create another burst of investments, both public and private. However, I'm skeptical that we will ever really go back to the Golden Era because then it was manufacturing jobs. They needed the bodies to assemble these things. Recent developments are actually more labor saving. If driverless cars come in we don't need people driving buses and trains anymore, so there will be less employment. So I can see a world where investment picks up but not employment as we had back in the Golden Era.

JS: Assuming no inflation, what do you think is the most relevant economic policy with regard to regulations?

Koo: For the pursued economies to remain advanced we have to stay ahead of others. How do we do that? Somebody has to come up with new ideas, new products and so on quickly enough. For those people to be operating at full capacity we want to ensure the environment is right for them. If regulations restrict their creative efforts, we all lose. So I am a strong advocate for deregulation in many areas so that these new businesses can prosper and we can stay ahead of our competitors.

BRICs & the US

JS: Will other developing nations soon catch up with BRICs, in particular with China?

Koo: China is a huge country. Parts of it — Shanghai, Beijing — are almost at the same level as any other advanced country but on average

per capita GDP is not very high. China has only about 15 years to go before its population starts shrinking. Their working-age population started shrinking in 2012. If demographic forecasts are correct, the total population will start shrinking in 2030. People's expectations are growing day by day and if those expectations are not met it could lead to social problems later on. Something we don't want to see.

JS: And the other BRICs?

Koo: They all have different challenges. Russia's industrial sector is so completely dominated by the energy part, so it is very difficult to get manufacturing going. India could probably move a lot faster if it could get over the various democratic and bureaucratic constraints. Consensus building in India apparently takes a long time. That's slowing growth there. Brazil got affected by what happened in the US. When the US was in sad shape after the Lehman crisis tons of money left and went into BRICs and quite a bit of that went into Brazil. That pushed exchange rates up, made asset prices higher because of the foreign capital inflow, and now they are suffering from the opposite.

JS: I'm curious about your view of the current situation of the US economy.

Koo: Well, we are genuinely in a low-inflation environment because we are all pursued economies. But having said that, these countries also did lots of QE, which was never attempted in the past. There are now enough reserves in the US banking system to increase US money supply 13 times if the private sector starts coming back to borrow. We're talking about a 1300% inflation rate. So instead of having low inflation we could have extra-high inflation. In order not to get into that mess the Federal Reserve is trying to normalize monetary policy before the private sector is ready to borrow. That's the problem we're faced with in the markets now; all this volatility because the Fed is trying to move forward, but the markets are saying wait a minute inflation is only 1.4%, what's the hurry? But from the Fed's perspective, if inflation is already 2% — the target range — that means the private sector is already coming back to borrow. If the Fed had to remove this massive excess of reserves in the banking system — $2.0 trillion of excess reserves at that time — chances are that interest rates will go sky high and that will kill the economy. We will be facing 2008 all over again. This is what Janet Yellen calls the "abrupt tightening scenario" which they want to avoid at any cost. So even though I don't think inflation will pick up, there's so much money sloshing around in the US banking system because of QE that the Fed cannot take that risk — that if the private sector does come back we're going to have this massive inflationary explosion. So they have to act sooner than a central bank that did not do QE. That's where the volatility that we see in the market originates.

Concerns about Geopolitical Risks

JS: Do you think geopolitical risks will be greater than economic risks in 2017?

Koo: Well, yes. In Europe, particularly, with what some people call "neo-Nazi" parties. This is a repeat of what happened in Germany in 1933. They were in balance sheet recession, but the government did not put in the fiscal stimulus due to opposition from Allied governments. As a result, German people were so badly hurt that they ended up voting for Hitler. He argued for both fiscal expansion and to stop paying reparations and when he did that the economy improved — massively, actually. We don't want to see that repeated in Europe, so I really hope the European governments will pre-empt these political parties by doing the right thing before it is too late. Because if Europe enters that kind of world and the US turns more inward-looking with President Donald Trump, then it is the stability in Asia where we have the greatest risk.

JS: China also has geopolitical risks.

Koo: That's what I mean. But if Europe and the US stay strong then there's only so much China can stir up. But if these two areas get preoccupied with themselves and become inward-looking, then that will give China space to play a few more games.

Future of Economics

JS: You've suggested that traditional economics are outdated, so what kind of economics should be read today?

Koo: Macro-economics is a very young science. It only started around 1945 after John Maynard Keynes' book came out in 1936. That was just the Golden Era of the West. They were ahead of everyone else, no one was chasing them, and a lot of new products were being invented: cars, cameras, washing machines. Plenty of demand for funds. Now we don't have that world. But because that's the only analytical experience we have so far, economists are still using the tools developed during the Golden Era to try to handle the situation in the pursued world. But of course they don't work. So I think the whole profession is losing credibility. JS

Written with the cooperation of Ian de Stains OBE who is a writer and consultant.