

Time is Running Out, Even For Countries With Low Borrowing Costs.

How does one put an economy in order? An economy is like a business, but it is a lot more complex, with more stakeholders. Still, a business in distress is a good starting point to try to find a way out.

Let's look at a generic economy with

- Large quantity of public debt
- Slow economic growth
- A global recession and thus a sluggish external sector
- Persistent unemployment
- Shrinking private debt
- Stagnant housing market
- Independent central bank
- A non partisan government (for simplicity)
- Strong intellectual property capabilities.
- The country's currency is the de facto global reserve currency.

What are the problems we seek to solve?

- Lower unemployment
- Raise economic growth
- Pay down public debt

Let us clarify the problem somewhat.

- Government deficits are rising as the government attempts fiscal reflation, for example through tax cuts and the limited provision of such public goods as healthcare.
- The central bank has so far been able to monetize government debt so as to keep interest rates low. The private sector has sterilized most of the monetary expansion. That said, the size of the monetary base presents a

precarious position for the central bank in terms of price stability. The internal and external purchasing power of the currency may be questioned.

An initial solution:

- The government should raise as much long term debt as it can and quickly. It needs to **remove all refinancing risk for the next 5 to 7 years**. Once it has fixed its borrowing costs for a sufficiently long period into the future, it will no longer face the discipline of the bond market. It does not face this discipline today, but it may in future. It needs to lock in financing while it pursues unconventional fiscal policy (as opposed to unconventional monetary policy, which was required to bootstrap the unconventionally fiscal policy in the first place.)
- Operate an open door policy for business and capital. This may be unpopular and expensive at first. Expensive: It involves **cutting marginal income tax rates and corporate tax**. This may create a larger deficit in the short term but the tax elasticity of domicile will reverse the deficit given more time. This strategy is proven but it takes resolve as the initial finances deteriorate. Unpopular: Tax reform has to be designed to attract foreign capital and talent. This is a beggar-thy-neighbor policy which will be unpopular with trading partners and other countries as well as with incumbent residents who may see a deterioration of wealth and income equality. The current situation sees major economies competitively pushing capital and human resources away, counter to the more rational strategy of attracting capital and human resources.

A longer term solution:

- **A government should only provide goods and services which the free market is unable or unwilling to provide.** This defines the scope and scale of government, not political ideology. Shrink the government to fit. Ideally, taxes will be kept low. This is a mathematically sound approach but it does leave open the question about the use of taxation as a redistributive policy. We have noted before that the free market tends to increase the level of inequality in the system. This is outside the scope of this discussion.
- **Address the major areas of moral hazard in the economy.** Central banks and

regulators should be responsible for the long term stability and sustainability of the financial system, to promote efficient allocation of resources, to promote full employment and most of all, to ensure a level playing field for all participants. Long term stability sometimes requires short term volatility to condition participants to the risks of participation. Efficient resource allocation requires minimum price distortion which will also require central banks to reexamine their role in the determination of interest rates, arguably the most important price of all.

- **Economic reform** in labour markets, particular industries, professions, banking and finance, public goods, etc etc are all well and good, but lets not be too ambitious. It is far from clear that we will even get to the initial solution let alone the longer term solution.
- **A reexamination of the capitalist system of economics.** Since the death of communism, capitalism has spiraled out of control without a nemesis or counterbalance. This economic soul searching can be pre-emptive or it can wait until a sufficient proportion of the global population is sufficiently disenfranchised by the particular distributive nature and inequality of wealth, income and opportunity of the current capitalist system.

Looking at how we have progressed thus far, some countries still have the means to refinance themselves sufficiently far into the future to employ the above strategy. Others do not. For these, the future is grim. Where countries have been given time and the benefit of the doubt by the capital markets, the time to act is decaying quickly.