

# How to prevent a depression

AMSTERDAM – 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 an economic and financial crisis even worse than the previous one – now involving not just the private sector, but also near-insolvent sovereigns – 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 eurozone's periphery are forced to undertake fiscal austerity, countries able to provide short-term stimulus should do so and postpone their own austerity efforts. These countries include the United States, the United Kingdom, Germany, the core of the eurozone, and Japan. Infrastructure banks that finance needed public infrastructure should be created as well.

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 hike 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, labor, real estate, and commodity markets feeds disinflationary pressures.

Third, to restore credit growth, eurozone banks and banking systems that are under-capitalized should be strengthened with public financing in a European Union-wide program. 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 to solvent but illiquid SMEs 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.

Today, Spain and Italy are at risk of losing market access. Official resources need to be tripled – through a larger European Financial Stability Facility (EFSF), Eurobonds, or massive ECB action – to avoid a disastrous run on these sovereigns.

Fifth, debt burdens that cannot be eased by growth, savings, or inflation must be rendered sustainable through 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 eurozone countries are given significant debt relief, economic growth will not resume until competitiveness is restored. And, without a rapid return to growth, more defaults – and social turmoil – cannot be avoided.

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

- A sharp weakening of the euro towards parity with the US dollar, which is unlikely, as the US is weak, too.

· A rapid reduction in unit labor 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 cannot work, the sole alternative is an exit from the eurozone 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 eurozone members. The balance-sheet effects on euro debts caused by the 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 eurozone 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, the advanced economies need a medium-term plan to **restore competitiveness and jobs via massive new investments in high-quality education, job training and human-capital improvements, infrastructure, and alternative/renewable energy**. Only such a program can provide workers in advanced economies with the tools needed to compete globally.

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, like 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, especially if the eurozone crisis becomes disorderly and leads to a global financial meltdown. Wrong-headed policies during the first Great Depression led to trade and currency wars, disorderly debt defaults, deflation, rising income and wealth inequality, 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 and aggressive global policy action now.