

The World in Balance Sheet Recession

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Summary

There is quite a bit of confusion in the policy circles, in the academic circles and also in the markets regarding the international economic situation unleashed by the 2007-2008 crisis. And, as there is so much confusion, the economic policy responses have been largely inconsistent, not only in the United States but also all around the world, and this might be prolonging the recession unnecessarily. However, what we are currently going through happened in Japan exactly 15 years ago. What is happening now is that, after the bursting of the bubble, the private sector is deleveraging or reducing its debt to a minimum. This is called a balance sheet recession. And, in this type of recession, cutting the interest rate to zero and increasing the monetary base do not translate into an improvement of credit to the private sector and into a recovery of economic activity. The monetary policy becomes ineffective. As shown by the Japanese experience, the response to prevent the collapse of economic activity lies in the fiscal policy, i.e. the government should increase spending by financing itself with the savings the private sector generates in order to deleverage. Only after the balance sheets have been repaired and the private sector is willing to, and may, get into debt, should the government start to cut its budget deficit.

JEL: E30, E44, E52, E62, G01.

Key words: balance sheet recession, deleveraging, fiscal policy, international financial crisis, monetary policy.