Jon Nicolaisen: Can crises be curbed?

Speech by Mr Jon Nicolaisen, Deputy Governor of Norges Bank (Central Bank of Norway), at the Norwegian Academy of Science and Letters, Oslo, 12 April 2016.

* * *

Please note that the text below may differ slightly from the actual presentation.

Keynes versus Hayek

On 17 October 1932, a letter on the subject of public and private spending was published in *The Times* newspaper. The letter was signed by several economists, one of whom was John Maynard Keynes. In the letter, Keynes argues in favour of public spending:

> *"If the citizens of a town wish to build a swimming-bath or a library, or a museum, they will not, by refraining from doing this, promote a wider national interest. [...] Through their misdirected good will the mounting wave of unemployment will be lifted still higher."*

Two days later, on 19 October 1932, another letter was published in response. This letter was also signed by several economists, among them Friedrich Hayek:

> *"... many of the troubles of the world at the present time are due to imprudent borrowing and spending on the part of the public authorities. [...] the existence of public debt [on a large scale] imposes frictions and obstacles to readjustment [...] If the Government wish to help revival, the right way for them to proceed is, not to revert to their old habits of lavish expenditure ... "*

The debate between Keynes and Hayek took place at a time when millions of people were out of work. Governments, firms and households were heavily in debt and many banks were on their knees. In many countries, deflation made debt even heavier to bear. At the same time, pessimism and caution put a damper on the willingness to spend. Deflation and unemployment led to a low level of consumption, and investment that could have generated jobs and growth was held back.

The question is, then, can the authorities curb a crisis by spending borrowed money? According to Keynes, spending would not only prevent the economy from sinking even lower, it would also reduce the extent of the crisis and bring the economy back into balance more quickly. Or was Hayek right when he claimed that misjudged attempts to curb a crisis by means of debt-financed spending can sow the seeds of a subsequent and even deeper crisis?

According to Hayek, measures should be focused on the underlying challenges, such as public debt, that had created the crisis. In Hayek's opinion, higher public debt would inevitably end up funding unproductive investments and consumption in the public sector, which would lead to low growth. Instead, government budgets should be brought into balance and regulations hampering economic activity should be removed. In Hayek's view, this would over time provide the basis for healthy, self-driven economic growth, even if the measures taken might deepen the crisis in the short term.

Keynes won the public debate in the 1930s. His views influenced economic policy in the West, particularly in the post-war years. However, Keynesian policies would later prove to have their weaknesses too.

Deeper causes

Major crises are usually the result of a series of unfortunate events that occur in close proximity in time. A triggering factor can often be identified. But there is often an equally important and deeper underlying cause. If this is overlooked or not dealt with, the road out of the crisis may be long. Let me give an example from Norwegian economic history:[1]

The oil price shock in 1973 and 1974 led to a recession in western economies – the worst recession since the Second World War. The Norwegian economy was also affected. At the same time, the Norwegian oil age had just begun. With prospects of high future income, the authorities responded with an expansionary countercyclical policy with large fiscal deficits. Targeted measures were also implemented to help manufacturing through the most difficult period. Manufacturing firms operating at a loss received funding support to cover hourly wage costs and support for production for inventory. The aim was to curb the crisis.

But the diagnosis was wrong. What was interpreted as a cyclical problem was fundamentally a structural problem. There was a pressing need for restructuring. Norwegian industries – shipping and wood processing, shipyards and steel works – had allowed themselves to become dependent on high growth and cheap energy. High wage increases pushed up cost levels in manufacturing, and inflation accelerated, amplifying imbalances instead of solving problems and weakening international competitiveness even further. The current account deficit was record-high.

A countercyclical policy that resulted in labour market pressures and that kept firms alive artificially provided little help. It delayed restructuring, while inflation and fiscal deficits made restructuring even more urgent. Economic structures were protected rather than being reformed. Countercyclical policy became *counterstructural policy*.[2]

When economic policy changed course around 1980, the Norwegian economy started to get back on its feet again, but Norway's growth potential was low and new imbalances were building up. The fall in oil prices in 1986 sparked a new, and even deeper, crisis in the Norwegian economy.

The economic policy conducted in the 1970s was intended to follow Keynes' advice. Subsequent developments proved Hayek's point. To curb a crisis on a lasting basis, the measures implemented must also address the deeper causes of the crisis.

The global financial crisis was triggered by the Lehman Brothers bankruptcy on 15 September 2008. The crisis has been attributed to a number of factors. One important event was China's accession to the World Trade Organization (WTO) on 11 December 2001, almost seven years earlier. With China now a member of the WTO, the global labour force expanded considerably. Low wages and cheap goods from China exerted downward pressure on goods prices. As China's substantial savings surplus continued to grow, large amounts of savings were exported to the West. Inflation slowed in the decade following the turn of the millennium, in spite of high growth and falling unemployment. Combined with China's savings surplus, this resulted in persistently low interest rates.

Low interest rates coincided with weaker regulation of the banking and financial sectors, particularly in the US, but also in Europe. That proved to be a dangerous cocktail. Banks took more risk and levels of equity capital were too low. Household debt rose substantially. In many European countries, government debt ballooned in the shadow of low interest rates. When the crisis erupted in 2008, many were ill-prepared.

---

[1] Chap. 8 and 9 in Lie, Einar and Christian Venneslan (2010), *Over Evne: Finansdepartementet 1965 – 1992*, Pax, Oslo (Norwegian only).

[2] The expression "counterstructural policy" was used by Hermod Skånland in autumn 1977 when he wrote "The countercyclical policy conducted in Norway has to some extent also become a counterstructural policy". Skånland (1977): "Konjunkturperspektiver og norsk næringsliv" in *Sosialøkonomen* 10/1977, p.10 (Norwegian only).

Two aftershocks – China and Europe

The global economy is still struggling with the repercussions of the crisis, with record-low interest rates and overcapacity. Growth is low. In the past couple of years, growth has also slowed in Latin America and Asia. The number of unemployed in the EU has reached around 22 million. This is equivalent to the combined populations of Norway, Sweden and Denmark. Instead of being gainfully employed, workers are idle and their skills are eroding.

Unemployment is a waste of resources and a tragedy for the individual. A generation of young people are suffering the consequences, particularly in southern Europe.

Government debt is still high in European countries, and in many of them debt burdens have risen further. Government budgets are still showing sizeable deficits. Several countries have also experienced economic decline and deflation.

Overcapacity is high in China, particularly in heavy industry. Some manufacturing segments in other parts of the world are also facing excess production capacity, and profitability is low. Overcapacity and lower prices for manufactured goods are adding to global deflationary pressures.

Around half of China's steelworks are operating at a loss, and debt is rising.[3] China lacks efficient bankruptcy procedures, and as enterprises in heavy industry are mostly state-owned, the industry can be run at a loss. This makes it difficult to effect change. The US has imposed a penalty tariff on Chinese steel imports, and steel works in Europe are closing down.

If he was to comment on China's current situation, Hayek would have stated the following: Debt in the steel industry and other heavy industry must be restructured. Industrial enterprises that are running at a loss should be closed down. Chinese authorities now appear to be doing just that.

In the 1930s, many countries resorted to devaluations, tariff barriers and regulation of cross-border capital movements to protect their own manufacturing industry. But this was the wrong medicine. World trade fell, and the international division of labour went into reverse. This led to lower income for everyone. In his letter to *The Times*, Hayek made the following comment:

> *".... the right way [...] to proceed is [...] to abolish those restrictions on trade and the free movement of capital which are at the present impeding even the beginning of recovery."*

Today, the global system of trade and cross-border investment is again under pressure. In both Europe and the US, influential groups have argued in favour of erecting new walls and barriers to the international exchange of goods. This is a recipe for yet another downturn.

Norway is a small open economy with substantial wealth invested abroad. As a nation, we are completely dependent on a functioning international system of free trade and investment. In the short term, major economies have less to lose from closing themselves off. We trust that they will not, after all, abandon the global economic system that has been built up over the past 70 years.

Hayek or Keynes?

The current situation on our continent – Europe – has much in common with the 1930s. Unemployment is high, while there is a need for investment in infrastructure, new technology

3 Data from CEIC Data Company, which uses China Iron and Steel Association (CISA) as its source. According to CEIC, debt-to-equity ratios at these companies are around 70 percent, up from 50 percent in 2001.

and education. There are also many advocates of investing in a “green” shift towards sustainable growth.

But investment is not forthcoming. In the light of the pessimism now holding sway in Europe, this is perhaps not surprising. As Keynes wrote in his letter in 1932:

> *“.... the [released] real resources do not find a new home waiting for them. In present conditions their entry into investment is blocked by lack of confidence.”*

Keynes would have said that this is the time to deploy public investment to create jobs for idle labour. The cost to society would be low. Wages would replace expenditure on benefits and social security. Value-added would be generated, unemployment would decrease and employment would rise. This solution seems obvious. But it is not happening.

In southern European countries in particular, government debt is high and growth is low. Future public funding is tied up in servicing debt and funding public services and pensions. Public administrations are cumbersome, inefficient and often over-staffed. The willingness and ability of governments to increase taxes, and perhaps the public’s confidence in the authorities, is low.

The trap many European countries fell into was accumulating debt and spending borrowed money in *good* times, leaving them without the fiscal muscle to pursue a rational countercyclical policy in the face of crisis. This has made the economic downturn even heavier to bear.

A number of European countries have experienced stagnation or a fall in GDP – some have faced a considerable decline in nominal GDP. As a result, debt to revenue ratios have increased, further reducing the ability to escape the debt crisis. The unrest surrounding Europe is not making matters any easier. The Russian economy is struggling. There is war in the Middle East and Libya. And on top of high levels of debt and mass unemployment, countries all over Europe are now facing terrorist threats and a refugee crisis.

Only a few north European countries – including Norway – still have room for manoeuvre in fiscal policy. These countries have a savings surplus and export capital. But there are few northern European countries, including those within the EU, willing to finance southern Europe’s expenses over the tax bill – be it for refugees or for investment. With a common currency, euro area countries cannot rapidly adjust relative intra-area wages and prices. And there is no European federal government to enforce large-scale transfers from the north to the south.

Building up even more debt is rarely the way to resolve a debt crisis. If a household, firm, bank or government has become too heavily indebted, all experience to date indicates that, sooner or later, the debt will have to be restructured.

Hayek would probably have reiterated the view he expressed in 1932:

> *“ ..... the existence of public debt [on a large scale] imposes frictions and obstacles to readjustment very much greater than [the frictions and obstacles imposed by] the existence of private debt.”*

Perhaps Hayek, originally from Austria, had in mind Germany’s enormous reparations debt from the First World War, which probably contributed to the fall of the Weimar Republic.

We should not exaggerate: after all, Europe is still a region of peace, prosperity and cooperation. This is perhaps the greatest difference between the current situation and the 1930s. Nonetheless, the 1930s taught us that deep economic crises can also have substantial social and political consequences.

The European Central Bank – the ECB – is the only institution in Europe that can have a material influence on developments across the continent in the short term. The ECB is keeping government debt yields low by means of record-low policy rates and large government bond purchases. This is keeping the wheels in motion. It is also supporting government finances in a number of European countries. In today's situation, private investors would probably have required considerably higher yields on sovereign bonds – as was the case in 2011 and 2012 – if they did not know that the ECB was buying large volumes of these bonds.

No treatment is without side-effects. The same goes for low interest rates: there is little incentive to reduce debt and measures that could have strengthened government budgets can be postponed. Firms that are not making money can continue to operate.

Monetary policy in Europe has been stretched to its limits. What monetary policy can do is to build a bridge – from the old economy in crisis to a new economy. But someone else – and something else – must create solid ground on the other side. Otherwise, the bridge will be left hanging in mid-air.

Keynes would probably have supported the ECB's policy. Without countermeasures, a crisis can become a catastrophe. A slower process of economic restructuring may be a reasonable price to pay.

Europe is again seeing a modest pick-up in economic growth. Unemployment has reached the peak and is falling in countries such as Germany, Ireland and Spain. It is a slow process and the ordeal can seem unnecessarily protracted, but at least things are moving in the right direction.

Can the crisis in Europe be curbed? The answer is probably yes, provided authorities succeed in establishing a form of coordination that has so far been absent. At a deeper level, there is a need for structural and institutional reforms.

Such reforms will take time.

Immune system

The situation in Europe illustrates how difficult it can be to curb a crisis once it has arisen. It might therefore be wise to give priority to crisis prevention. A healthy economic system is less vulnerable. Crises can be curbed – or even avoided – by boosting the resilience of the economy. Rather than treating the disease after it has taken hold, much can be accomplished by strengthening the economy's immune system.

The financial crisis revealed deficiencies and system failures worldwide. Many governments and households had taken on too much debt. US investment banks such as Lehman Brothers operated a high-risk business model with low levels of equity. European banks were too dependent on short-term funding in international markets.

In a period of growth, it is easy for banks to obtain funding. But the system is fundamentally unstable. Without adequate capital requirements in the banking system, credit growth can spiral out of control.

Hayek gave lectures on this topic at the London School of Economics in the early 1930s.[4] The LSE is still home to many economists who argue against the risks of debt-financed growth.[5]

Solid banks are built in good times. Solid banks bolster the resilience of the economy and make crises easier to manage. Since the financial crisis, the G20 countries have implemented substantial changes in the global regulatory framework for banks. Under new

---

4 See Wapshott, Nicholas (2011): *Keynes Hayek: The ClashThat Defined Modern Economics*, New York, London: W.W. Norton & Company, Inc., pp. 72–78.

5 For the past few decades, Charles Goodhart has been a leading researcher at the London School of Economics (LSE) within both monetary policy and financial stability. Another well-known researcher in these areas at the LSE is former Governor of the Bank of England Mervyn King.

rules, investors are required to take losses if large global banks encounter difficulties.[6] A system for joint supervision and resolution of systemically important banks was put into operation by the euro area countries in 2014 and 2015.[7] This is great progress. A credible global system for crisis management and bank regulation will in itself contribute to crisis prevention.

Bank's capital requirements have increased, in Norway as elsewhere. This is a good thing. We are going to need solid banks.

Reforms and economic restructuring

The Norwegian economy is not in a crisis, but we are facing a period of restructuring. We have been in a similar situation before – when oil prices fell in 1986. The crisis that ensued eventually also led to positive changes. In the wake of the crisis, the authorities implemented reforms through the first half of the 1990s that laid the basis for renewed economic growth. The Act establishing the Government Petroleum Fund was adopted in 1990. Banks were instructed to increase efficiency. The 1992 tax reform streamlined the tax system and tax rates were substantially reduced. It became easier for investors to find projects that yielded high returns. State-ownership policy in Norway was changed to introduce a clearer division of roles and healthier commercial principles. And not least, the EEA Agreement provided access to the European Single Market for most of the Norwegian business sector.

When oil prices fell again in 2014, Norway was better prepared. But as a nation, our income has nonetheless been reduced by the fall in oil prices and we should be cautious about introducing measures that will increase consumption. Reasonable measures in a period of restructuring are those that promote economic growth over time, without crowding out private enterprise.

Monetary policy can facilitate restructuring. And it is able to do so because there is confidence that inflation will remain low and stable. With low and stable inflation, a weaker krone and higher import prices will not pass through to wage growth and inflation, as was the case after the fall in oil prices in 1986. On the contrary, the depreciation of the krone over the past couple of years has compensated for more than a decade of high cost inflation. This has improved the competitiveness of Norwegian firms – in foreign and domestic markets. In addition, lower interest expenses are easing the burden for many households and firms.

There is still room for manoeuvre in monetary policy. In contrast to most European countries, Norway also has room for manoeuvre on the fiscal front, if necessary. But – as in the rest of Europe – the authorities cannot solve the deeper challenge, namely the need to establish new private sector activity. This is a task for the business sector. What the authorities can do is to establish framework conditions that promote innovation and growth.

Hayek and Keynes

In my introduction, I posed the question: can crises be curbed? quickly followed by: can *misjudged* attempts to curb a crisis sow the seeds of an even deeper crisis?

Keynes and Hayek did not come to agreement on how a crisis should be managed. Their debate is still relevant today. Keynes advocated the use of public spending to curb crises.

---

6 See Financial Stability Board (FSB) (2011), "Key Attributes of Effective Resolution Regimes for Financial Institutions" and FSB (2015) "Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution".

7 The first pillar of the European Banking Union, the Single Supervisory Mechanism (SSM), with the ECB as supervisory authority for the 130 largest banks in the euro area, started in November 2014. The second pillar of the European Banking Union, the Single Resolution Mechanism (SRM), became operational in January 2015 and the joint crisis resolution authority, the Single Resolution Board, started its work.

Hayek warned against such a policy: the misjudged application of government measures could easily lead to deeper crises and credit bubbles.

Both were right. Crises can and should be curbed, using measures to strengthen the economy's immune system as well as measures that reduce the impact once the crisis has erupted. This means that government intervention using public funds may be the right approach in a situation of decline and deflation, low interest rates, high unemployment and pessimism. But crisis-related measures must also be focused on the deeper causes of the crisis in order to strengthen economic sustainability over time. Countercyclical policy must not become counterstructural policy.

Crises are not necessarily just an evil. A crisis can lead to reforms and measures that foster progress, as it did in Norway in the 1990s. The regulation of the banking sector in the wake of the global financial crisis is another example. Experiences such as these may give us some comfort in the bleakest of times. The world will go on, even after a deep crisis.

Thank you for your attention.