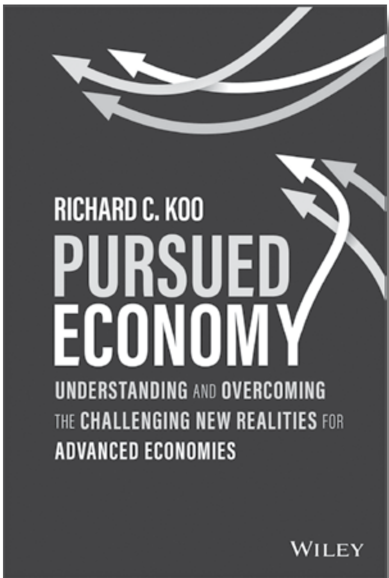
Pursued Economy



A condensed excerpt from **Pursued Economy: Understanding and Overcoming the Challenging New Realities for Advanced Economies** *by Richard Koo (Wiley, 2022).*

Directed by independent commissions, borrowing for infrastructure spending is the new economic model.

The most fundamental macroeconomic challenge for all pursued economies, those advanced countries where the return on capital is lower than that available in emerging economies, is that households are still saving for an uncertain future, much as they always have, but businesses are unable to absorb those savings because they cannot find enough domestic investment opportunities, even at very low interest rates. While most authors pay attention only to the debt numbers, it is the savings numbers in these countries that are most disturbing.

Figure 1 [Figure 4.1 in the book] shows that the net borrowings by the U.S. non-financial corporate sector have been zero on average since 1990 in spite of very low interest rates. This marks a huge change from the 1970s and 1980s, dubbed "golden era" here, when businesses were eagerly borrowing and investing on average 3.14 percent of GDP. Similar developments have been observed in other advanced countries. In Japan, for example, the sector borrowed on average 5.96 percent of GDP in the 1980s, but actually saved on average 1.85 percent of GDP since the 1990s.

This shrinkage in net corporate borrowings is an existential challenge for all pursued economies because if the household sector is saving but the corporate sector is not borrowing, someone else outside the private sector, i.e., the government, must borrow and spend that money to keep the economy from sliding into deflation. And Japan's decades-long deflation had a lot to do with its businesses not borrowing money.

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This a monumental challenge for governments because the public debt has already reached very high levels in most advanced countries, and the "pursued era" can go on for decades in today's globalized economy. This challenge is similar to the problem that economies in balance sheet recessions confront. In a balance sheet recession, it is the millions of underwater balance sheets following the bursting of a debt-financed asset bubble that lead to the disappearance of private-sector borrowers, whereas in pursued economies, it is the lack of attractive domestic investment opportunities that produces the same outcome. In both cases, the problem could last for years.

Japan's decades-long deflation had a lot to do with its businesses not borrowing money.

FUNDAMENTAL SOLUTION TO FUNDAMENTAL PROBLEM

The key to addressing this seemingly impossible challenge for pursued economies can be found in the ultra-low government bond yields that all these economies were experiencing, at least until the post-Covid supply constraint-driven inflation pushed the yields higher. These low bond yields are an indication that there are insufficient corporate borrowers relative to household savers. It is also an invitation to the government to identify and implement public works projects capable of producing a social rate of return in excess of those yields. If such projects can be found, fiscal stimulus centered on them will enable the government to act as borrower of last resort without placing an added burden on future taxpayers.

The most important macroeconomic challenge for policymakers in pursued countries, therefore, is to find infrastructure and other projects capable of earning social

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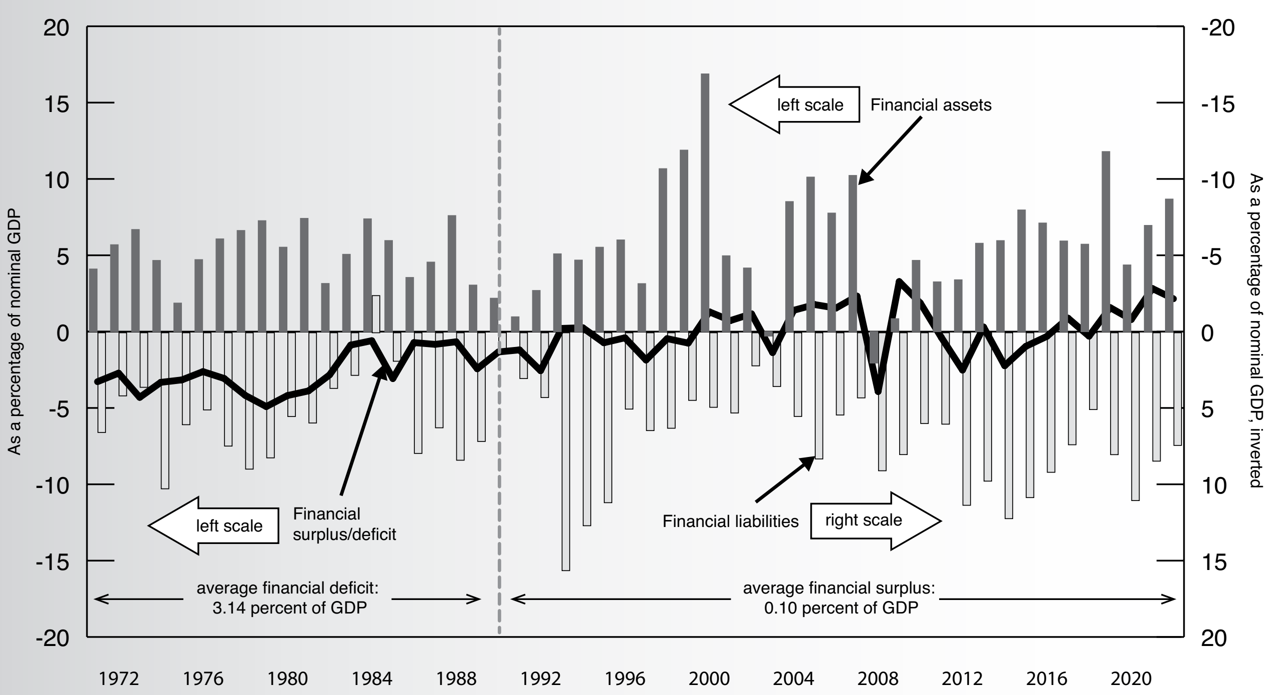
Figure 1 U.S. Businesses Stopped Borrowing Money After 1990



Note: Figures for CY2022 are four-quarter moving averages through April–June 2022.
Sources: Nomura Research Institute, based on the data from Federal Reserve Board and U.S. Department of Commerce.

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rates of return in excess of these low government bond yields. As long as such projects can be identified and implemented, the economy will continue to do well even though it is being pursued (or is experiencing a balance sheet recession). Pursued economies should therefore mobilize their best and brightest to find and implement such projects instead of wasting time worrying about the size of the public debt.

For example, thoroughly modernizing the ancient rail link connecting Washington, D.C., and Boston in the northeast corridor of the United States would almost certainly have a social rate of return that is many times higher than the present ten-year Treasury bond yield, which is around 4 percent. Upgrades to internet connectivity are also likely to have a very high social rate of return in many parts of the world. These are the kinds of projects that fiscal authorities in pursued economies desperately need to consider to keep their economies going.

In contrast, few public works projects are "self-financing" in the golden era, when high domestic return on capital encourages corporate borrowings and keeps interest rates high. That means the policy option of undertaking self-financing public works projects is largely unavailable during the golden era.

NOT A JOB FOR THE PRIVATE SECTOR

Some may argue that if such self-financing projects exist, they should be undertaken by the private sector instead of by the government. There are two reasons why that may not work. First, private-sector businesses are under pressure from shareholders to maximize their return on capital. That means that even if there are self-financing projects at home, businesses must invest abroad if higher returns are available. Since the government has no mandate to maximize its return on capital but is expected to keep the economy out of a deflationary spiral, it can and should implement public works projects to keep the economy from contracting.

Second, the rate of return that is relevant here is the social rate of return. This rate captures all externalities, which private-sector operators may not be able to do. In other words, there may be projects that do not offer sufficiently high returns as private ventures but that make sense as public projects because of their positive externalities for society as a whole.

INDEPENDENT COMMISSION NEEDED TO SELECT AND OVERSEE PROJECTS

To achieve this shift of emphasis from monetary policy in the golden era to fiscal policy in the pursued era, the country will need an independent commission consisting of highly trained experts who can judge whether projects are likely to produce a social rate of return in excess of government bond yields. These calculations are not at all easy or straightforward, since a typical public works project involves many externalities that are hard to quantify but will have to be considered before making a final judgment. If the selected projects turn out not to be self-financing, they can literally extinguish a country's economic future by burdening taxpayers with costly white elephants and a massive debt load.

The most important macroeconomic challenge for policymakers in pursued countries, therefore, is to find infrastructure and other projects capable of earning social rates of return in excess of these low government bond yields.

The importance of this commission's independence cannot be overemphasized: its independence is no less important in a pursued era than the central bank's is in a golden era. There are historical examples of such commissions. When the United States was closing military bases after the end of the Cold War, an independent commission was set up to decide which bases to shut down. Although there were some complaints from politicians in affected districts, the process went reasonably smoothly.

Even if the commission is not given the final say on which project gets implemented, just having a credible independent commission vetting projects and ranking them should go a long way in influencing the debate on which project should be funded. Inasmuch as pursued economies are likely to remain in that state for an extended period, there is no time to waste in developing the human capital and the legal framework needed for these independent fiscal commissions. ◆