Policymakers are wondering when and how to start a delicate task: weaning the world economy off fiscal and monetary stimulus.

THE world economy has been injected with the biggest Keynesian cocktail yet seen in peacetime. In the past 18 months governments have pumped cash into their economies to fight financial seizure and recession. Central banks have slashed interest rates (see chart 1); the rich world’s largest ones have supplemented ultra-cheap money with a special drug, quantitative easing (QE). Finance ministries have cut taxes and boosted public spending.
This infusion has had a dramatic effect. It prevented the biggest financial bust since the 1930s from triggering an economic catastrophe. Banks were stabilised, asset prices rebounded and the global recession, though the deepest since the second world war, was no second Depression. The pace of recovery varies, but every big economy has stopped shrinking.

Although by most measures the world economy is out of intensive care, it is hardly in good health. Big emerging economies are growing briskly, but in many rich ones, notably in Europe, the recovery is fragile. Growth is still heavily dependent on government stimulants, even as their side-effects are becoming clear. In China, a huge, state-directed lending binge has propped up demand but is also fuelling asset bubbles, especially in property. As big, rich economies’ budget deficits have risen more than fourfold, to an average of 9% of GDP (see chart 2), public debt has started to shoot up. In the euro zone, in particular, investors are getting nervous. The recent leap in Greek bond yields and the pressure on Portugal and Spain suggests that some governments may soon run out of fiscal room.

All this leaves policymakers with an unenviable task: deciding when and how to withdraw the drugs. An “exit strategy”, in official jargon, requires answers to three questions. First, timing: when should fiscal and monetary tightening begin? Second, tactics: is it more important to start by cutting budget deficits or by
You shouldn’t start from here

Begin with the timing. Policymakers have to avoid doing too much too soon, which could kill a frail recovery, and doing too little too late, which could lead to budgetary crises and inflation—or to a bond-market rout as investors anticipate trouble. The course of action is clear when the recovery is robust, as it is in big emerging markets and rich countries far from the centre of the financial crisis. Their economies have little spare capacity and no reason to keep monetary or fiscal policy at emergency settings. It is no surprise that they have been the first to tighten.

Australia, Israel and Norway increased interest rates late in 2009. A month ago China raised banks’ reserve requirements and began to clamp down on lending. India’s central bank followed suit, raising reserve requirements on January 29th. Fiscal policy is also being tightened. Brazil (see article), India and Mexico all plan to cut their underlying deficits this year.

The task is harder in big, rich economies, where growth is more fragile. Central banks have made a start, mainly by unwinding the emergency liquidity facilities with which they fought financial panic. Five of the Federal Reserve’s seven crisis-lending windows were closed on February 1st. The European Central Bank (ECB) has stopped lending banks unlimited 12-month funds. The currency swap lines that central banks set up among themselves have also been shut down. QE—creating money and using it to buy bonds—is coming to an end, or at least pausing. On February 4th the Bank of England said it was halting its purchases of gilts, though Mervyn King, the governor, said it was "far too soon to conclude that no more would be needed." The Fed is buying fewer mortgage-backed securities and plans a full stop by April. Ben Bernanke, its chairman, laid out its tools in congressional testimony on February 10th, but made it clear that the Fed was not about to tighten policy.

Fiscal policy is more disparate. Some countries are loosening further. In America, Barack Obama’s recent budget proposed tax cuts and spending worth an extra 1.8% of GDP in the next two years. Japan has also added to its deficit spending plans. Many more countries, such as Germany, will see budget deficits rise as parts of earlier stimulus packages kick in.

Elsewhere tighter budgets are at hand, even in weak economies. Bond-market troubles are forcing Greece’s government to freeze public-sector wages and raise taxes, and causing Portugal’s and Spain’s to accelerate budget cuts. After its election, due by June 3rd, Britain seems due for similar treatment, especially if the Conservatives take over from Labour.

The list of rich countries forced into austerity by the markets is still short—and confined to weaker members of the euro zone, not least because they cannot devalue their currencies. But it could lengthen if growth remains anaemic and deficits stay high. Modern, global capital markets have never seen a rise in public debt so fast or so skewed towards the rich world. The average ratio of public debt to GDP in big, rich economies has jumped from below 80% to nearly 100% in two years. The IMF reckons it will near 120% by 2014. Meanwhile, big emerging economies’ ratios are likely to decline. The perceived relative riskiness of rich countries’ debt could well rise—and so could their relative bond yields.

Domestic politics may also squeeze budgets. Tighter policy is usually unpopular, but that can change. In America, opinion has shifted sharply in the past year as more people doubt the efficacy of government spending and fret about the holes in the public purse. Despite Mr Obama’s looser budget, about 60% of Americans think deficit reduction should be the government’s main economic priority.

Given all this, two schools of thought are emerging on timing. The dominant one, which includes the IMF and the G7 finance ministers (who met on February 5th and 6th), thinks that when the risks are weighed up, it is too soon to tighten. The IMF, which believes that a “premature and incoherent” exit from stimulus is a serious danger for the world economy, wants no fiscal or monetary tightening in big, rich economies until 2011. As Dominique Strauss-Kahn, the fund’s boss, puts it: if countries start cutting budgets a year late, they will have an unnecessarily large debt burden. If they tighten too early, and the world economy relapses, the mess will be far bigger, not least because policymakers will be all but out of ammunition.
The smaller, but growing, school argues not only that Keynesian deficit spending has reached its limits but also that a serious effort at cutting deficits would boost confidence and thus counter the drag on demand from lower government spending. This view has adherents at the ECB, which wants faster fiscal retrenchment by members of the euro area. Britain’s Conservatives also belong in this camp. Partly this is political: a new government can blame the fiscal pain on its predecessor's failings. But it is also based on the belief that Britain would be better off if its deficit were cut sooner than Labour intends.

The logic behind this is derived from a theory called Ricardian equivalence, which holds that government spending cannot boost demand, since consumers cut their own expenditure in anticipation of higher taxes ahead. Though there is little to indicate that households behave in this way in general, there is evidence that when governments are heavily in debt fiscal stimulus becomes less effective, and investors' and consumers' confidence can deteriorate suddenly. And when debt-laden governments sort out their budgets, investors accept lower bond yields. Several studies show that the expansionary effect of lower interest rates has often outweighed the contractionary effect of lower government spending.

This might not work today. At 4%, British bond yields are already low by past standards. They have some room to fall, but not a lot. Nor, with credit tight and consumers keen to rebuild their balance-sheets, is it likely that greater confidence will boost private spending much. At best there is a precautionary case: without fiscal tightening, the Tories fear, bond yields are bound to rise, especially when the Bank of England stops buying gilts.

These competing theories don’t tell policymakers exactly when they should start tightening. But they do suggest where it is most urgent—and therefore who should start first. Small, open economies (such as Greece’s or Ireland’s) gain relatively little from looser fiscal policy, because a lot of the effect spills abroad. They also suffer heavily when investors lose confidence. Countries with heavy debt burdens (like Italy), whose tax base has collapsed (Ireland and Spain), which had a big budget deficit to start with (Britain) or whose long-term growth prospects have been hit hardest (Spain) should fear a sudden loss of investors’ confidence more than those with smaller deficits (Germany), better demographic prospects (America) or a reserve currency (America again). Japan, with the highest debt burden of all, weak growth and terrible demographics, ought to have lost investors’ confidence long ago, but thanks to a pliant domestic saver base, falls somewhere in between.

These differences suggest that the right time to start tightening fiscal policy will vary, even among countries with similarly weak recoveries. Those with more fiscal room (especially Germany, but also America) should wait longer than those (such as Britain) with less.

**Take a deep breath**

Eventually, however, all big, rich economies will have to cut their deficits and keep doing so for several years. How tight belts will have to be depends on the debt ratio that countries aim for, the size of their deficits, how fast they grow and the interest rates they face (see article). Countries that decide to live with higher debt burdens will, in the long run, grow more slowly than the prudent, as government debt crowds out private investment.

Roughly speaking, simply stabilising the debt ratios of big, rich economies at the levels forecast for 2014 would require an improvement, on average, of about 4% of GDP in primary budget balances (revenue minus spending, excluding interest payments). To bring ratios of debt to GDP back to 60%, a number widely seen as prudent prior to the crisis, would take twice as much effort. The average hides huge variations. Britain’s fiscal adjustment, as a share of GDP, would need to be more than three times as big as Germany’s.

This has been done before. In recent decades ten rich countries, from Canada to Ireland, managed to improve their budget balances by more than 10% of GDP. But they did not all do so at once. Nor, most importantly for today’s exit strategists, did they do so when short-term interest rates were already close to zero.

That leads to the second question, of the right blend of fiscal and monetary tightening. Most fiscal adjustments since the second world war have led to lower interest rates. Today central bankers have little room to offset budgetary austerity with cheaper money. In theory they could expand QE, but in practice none is keen. More likely, stricter fiscal policy will mean less monetary tightening than there would be otherwise. If the recovery is weak to begin with, and then slowed by budget cuts, short-term interest rates in the rich world could be
unusually low for several years.

At first sight, this is a good idea. The alternative—higher interest rates and big budget deficits—would mean larger, costlier debts. Loose money and tighter budgets also tend to lead to a weaker exchange rate, so this mix of policies would also speed up the rebalancing of the global economy, by weakening rich countries’ currencies relative to those of emerging markets. And because most rich economies have bags of spare capacity, and tighter budgets would restrict demand, inflation would be unlikely to accelerate.

This strategy has drawbacks nonetheless. Even if consumer prices are stable, a long period of ultra-low interest rates in rich economies is likely to fuel asset bubbles and other financial distortions—much as it did after 2003. This time central bankers might try to use regulations to pop incipient bubbles. For example, they might limit the ratios of mortgage loans to property values. Several Asian central banks do so already. Some in the rich world are quietly exploring the idea.

Years of cheap money in the rich world would pose problems for policymakers in emerging economies, as capital flooded in seeking higher yields. Some already have home-made difficulties. China’s refusal to allow the yuan to appreciate is already one of the biggest causes of distortion in the world economy. A stronger yuan would ease China’s inflation malaise and help in forming a global exit strategy.

However, blameless emerging economies, especially small, open ones, would also find domestic monetary stability hard to maintain. Left alone, their currencies could easily overshoot. Allowing a gradual appreciation often simply invites more foreign capital, as investors expect the currency to rise. Building up reserves makes control of inflation harder. Capital controls to stem the inflow look likely.

Those risks are probably worth taking, given the likely weakness of the rich world’s recovery and the scale of its fiscal task. Nonetheless, a carefully calibrated budgetary tightening, which allows central banks to move a notch or two from rock bottom, may be no bad thing. As Stephen Roach of Morgan Stanley puts it, the monetary dials should shift from the “emergency” setting to “simply lousy”. Many central bankers privately agree.

**Central bankers’ new tools**

The possibility that modest tightening makes sense even in a weak recovery raises the third, technical question, especially for central banks, such as the Fed and the Bank of England, that have made most use of unconventional measures. When they do decide to tighten monetary conditions, how do they do it?

Thanks to QE, central banks now have two policy levers: short-term policy rates, as before, and the size of their balance-sheets. Some people worry that by expanding their balance-sheets central banks have been playing with inflationary fire (see chart 3). The counterpart to their assets is banks’ excess reserve holdings with central banks. If banks decided to lend that money, credit could explode.
This is too simplistic, not least because central bankers have been busy creating means of holding on to the reserves if need be. All big central banks now pay interest on reserves. Several have new ways of draining reserves. Mr Bernanke said this week that the Fed, which has the widest range of novel measures, plans to offer banks term deposits, enabling it to lock up reserves for several months.

In principle, these devices mean that the size of a central bank’s balance-sheet should not affect its ability to influence monetary conditions. They even broaden its options. Central banks could raise short-term interest rates or they could steepen the yield curve by selling longer-dated assets from their balance-sheets.

In practice, the tools are untested. Central bankers will find it harder to know how they are affecting monetary conditions or to be clear about what they are doing. Mr Bernanke suggested, for instance, that the Fed could temporarily target the interest rate it paid on excess reserves, rather than the federal funds rate. If financial markets find central bankers’ actions more difficult to understand and anticipate, the way monetary policy is transmitted to the broader economy could be distorted.

There are political pitfalls too. In America, for instance, paying banks higher interest on excess reserves will sound to many like handing money to villains. Selling mortgage-backed securities would draw fire from politicians worried about higher mortgage rates. At a time when the Fed is held in low public regard, the stakes are high. A badly handled tightening, even if modest, could seriously threaten the central bank’s independence.

Adding together the uncertainty about the recovery’s strength, the scale of the coming fiscal adjustment and the technical and political difficulties facing central banks leads to three conclusions. First, policymakers do not have to worry only about when to start tightening: the mixture of fiscal and monetary policies must be coherent, too.

Second, that suggests central banks and finance ministries must co-ordinate their policies more closely than in recent years. Economists have long thought of monetary policy as the main means of managing the cycle; central banks have long feared that overt co-operation with governments would risk their politicisation. The opposite may now be true.

Third, the term “exit strategy” may be a misnomer. Weaning the world economy off fiscal and monetary stimulants will take many years. And like a former addict, the patient may never be quite the same again.

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