RICHARD C. KOO

THE OTHER HALF OF MACROECONOMICS

AND THE FATE OF GLOBALIZATION

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Preface

The advanced countries today face a highly unusual economic environment in which zero or negative interest rates and astronomical amounts of monetary easing have failed to produce vibrant economies or the targeted level of inflation. Simply trying to understand what zero or negative interest rates *mean* in a capitalist system sets the head spinning. One wonders how Karl Marx or Thomas Piketty would explain negative interest rates.

It was twenty years ago that the author came up with the concept of balance sheet recessions in Japan to explain why post-bubble economies suffer years of stagnation and why conventional monetary remedies are largely ineffective in such recessions. The key point of departure for this concept was the realization that the private sector is not always maximizing profits, as assumed in textbook economics, but will actually chose to minimize debt when faced with daunting balance sheet challenges. Once this fundamental assumption of traditional macroeconomics is overturned and the possibility of debt minimization is acknowledged, everything that was built on the original assumption—including many standard policy recommendations—must also be reconsidered.

It recently occurred to the author that the same insight can be used to explain periods of long-term economic stagnation throughout history because there is another reason for the private sector to be minimizing debt—or simply refraining from borrowing—in spite of very low interest rates. The reason is that businesses cannot find investment opportunities attractive enough to justify borrowing and investing. After all, there is nothing in business or economics that guarantees such opportunities will always be available. When businesses cannot find investments, they tend to minimize debt (except when tax considerations argue against it) because the firm's probability of long-term survival increases significantly if it carries no debt.

This shortage of investment opportunities, in turn, has two possible causes. The first is a lack of technological innovation or scientific breakthroughs, which makes it difficult to find viable investment projects. This probably explains the economic stagnation observed for centuries prior to the Industrial Revolution in the 1760s. Some also attribute the recent slowdown in advanced economies to an absence of innovative, must-have, "blockbuster" products.

The second cause is higher returns on capital overseas, which forces businesses to invest abroad instead of at home. For companies in the advanced countries, the rise of Japan in the 1960s and of emerging economies in the 1990s has changed the geographic focus of their investments. Businesses continue to invest in order to satisfy shareholder expectations for ever-higher returns on capital, but the bulk of their investments, especially in the job-creating manufacturing sector, are no longer taking place in their home countries. This probably explains the economic stagnation and slow productivity growth observed in advanced countries during the last two to three decades.

The bursting of debt-financed bubbles in Japan in 1990 and in the West in 2008 caused even more borrowers to disappear as these economies fell into balance sheet recessions. Advanced countries today are therefore suffering from two ailments, both of which discourage businesses from borrowing and investing at home.

The economics profession, however, failed to consider the macroeconomic implications of private-sector balance sheet problems until very recently. It never envisioned a world where businesses no longer invest domestically because the return on capital is higher abroad.

Even though all of the developed countries suffer from both of these issues, economists continue to recommend policies such as monetary easing and balanced budgets based on the assumption that the private sector is maximizing profits. But for that to be the case, the private sector must have a clean balance sheet and plenty of viable domestic investment opportunities. Neither assumption holds today.

The fact that most advanced countries are going through the same stagnation problems at the same time while emerging economies continue to attract capital from around the world also suggests that the effectiveness of monetary and fiscal policy changes as an economy undergoes different stages of development. This means those policies that were effective just a few decades ago many not be effective or appropriate today.

Because promised economic recoveries took far longer than expected or, for many, did not materialize at all, the public is losing confidence in the competence of established political parties and is starting to vote for outsiders and extremists, a dangerous sign in any society. Although a much-improved social safety net means that today's democracies are more resilient to recessions than those in the 1930s, democracy cannot survive if center-left and center-right leaders continue to pursue fundamentally flawed economic policies while people at the bottom suffer.

Once the root cause of stagnation and the failure of conventional economic policies is understood, the remedies turn out to be remarkably straightforward. To get there, however, we must discard conventional notions about monetary and fiscal policy that were developed at a time when the developed economies were not facing balance sheet problems or challenges from emerging markets.

The problem is that the discipline of macroeconomics was founded in the postwar years, when private-sector balance sheets were in pristine shape and new products ranging from television sets to washing machines were being brought to market one after another. That led economists to believe that the only *modus operandi* for the private sector was profit maximization. Convincing these believers that the private sector might sometimes behave differently has proven to be a challenging task because profit maximization is the pattern the discipline is identified with.

But rediscovering this "other half" of macroeconomics should not be too difficult inasmuch as the discipline's origins lie in Keynes' concept of aggregate demand, which was developed during the Great Depression, at a time when the private sector was aggressively minimizing debt.

The author first used the phrase "the other half of macroeconomics" to describe a world in which the private sector is minimizing debt in his 2008 book, *The Holy Grail of Macroeconomics*, which introduced the concept of yin and yang business cycles. The term has been chosen for the title of this book because its relevance goes far beyond post-bubble balance sheet issues.

Physics and chemistry evolved over the centuries as new phenomena that defied existing theories were discovered. In many of these cases, it was eventually realized that what people thought they knew was not wrong but was in fact a subset of a bigger truth. Similarly, the economics taught in schools is not wrong, but it applies only to situations where the private sector has a clean balance sheet and enjoys an abundance of attractive investment opportunities. When these conditions are not met, we have to look at the other half of macroeconomics, which is not based on those two assumptions.

This book started life as Part II of a joint book project with my brother John Koo, a well-known dermatologist, who came up with some fascinating insights on where civilization might be headed by applying scientific methods to analyze the evolution of religion and morality. Unfortunately, speaking engagements related to newly developed drugs for psoriasis have prevented him from completing his section of the book. But because the original target audience for this book was the non-specialist public, the author has tried to use as few specialized economic terms as possible so that those with minimal training in economics will still be able to follow the arguments. Besides, it is the author's belief that any economic phenomenon or theory must be explainable in plain language because its actors are all ordinary human beings going about their daily lives.

The author has also tried not to repeat the arguments put forth in his previous three books (eight in Japanese), but some of the fundamental concepts of balance sheet recessions are repeated in Chapter 2 for readers who are also encountering this concept for the first time. The challenges facing the Eurozone are also revisited in Chapter 7 because the fundamental defect in the system remains unaddressed, even though some European countries are doing better than before.

The times have changed, and everyone, economists included, must open their minds and broaden their vision to understand what is happening. There are also right ways and wrong ways to respond to that change. It is the author's hope that this book will help explain why policies that worked so well in the past no longer work today, and why nostalgia for the "good old days" is no solution for the future. Once the key drivers of change are identified and understood, individuals and policymakers alike should be able to respond correctly to today's new environment without wasting time on remedies that are no longer relevant.

An entirely new approach to analyzing the economic problemsof today's advanced countries, from a leading economist

The Other Half of Macroeconomics and the Fate of Globalization presents a totally new approach to macroeconomics that offers a solution to the challenges of stagnation and worsening inequality that trouble so many advanced countries.

Since the Great Recession of 2008, most of the developed world has been mired in stagnation. The repeated failures of central banks and governments to meet inflation or growth targets despite truly exorbitant levels of monetary accommodation have left the public justifiably suspicious of the establishment and its economists.

Richard C. Koo, a noted thought leader in economics and creator of the concept of *balance sheet recessions* – which triggered the current focus on debt in global policy debate – introduces the insightful new concept of *pursued economies* in this book. This concept shows that the effectiveness of monetary and fiscal policy changes as an economy undergoes different stages of development It also identifies the core drivers of the economic and political predicaments advanced nations face today and shows how these countries can move forward in the new global environment.

RICHARD C. KOO is the Chief Eco-nomist of Nomura Research Institute, where he is responsible for providing independent economic and market analysis to Nomura Securities, the leading securities house in Japan, and its clients. Best known for his theory of *balance sheet recessions*, Koo has advised several Japanese prime ministers over the last thirty years, and for the past ten years, he has advised numerous Western governments and central banks on how best to address post-bubble economic and banking problems. Before joining Nomura in 1984, Richard, a US citizen, was an economist with the Federal Reserve Bank of New York. Prior to that, he was a Doctoral Fellow of the Board of Governors of the Federal Reserve System. In addition to being one of the first non-Japanese to participate in the development of Japan's five-year economic plan, he taught at Waseda University in Tokyo as a visiting professor and is now a Senior Adv[illegible] Center for Strategic and International Studies in Washington, D.C.

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