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Book review

Koo, R.C. (2015): *The Escape from Balance Sheet Recession and the QE Trap: A Hazardous Road for the World Economy*, Singapore (320 pages, hardcover, Wiley, ISBN 978-1-119-02812-3)

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Richard Koo, the chief economist at a leading securities house, became a widely known author with the publication of his 2008 book, *The Holy Grail of Macroeconomics*, which introduced the concept of a balance-sheet recession. Koo argued there that while mainstream theory made sense in normal times, it did not in recession or stagnation times, when firms or households were attempting to reduce their debt levels, thus the term 'balance-sheet recession'. Koo argued that when agents try to deleverage, the economy is subjected to fallacies of composition, that is, to macroeconomic paradoxes. Under these circumstances, the paradox of thrift holds so that saving is a vice rather than a virtue, monetary policy is ineffective despite low interest rates, fiscal policy is effective and not subject to crowding-out effects, price deflation is the main worry rather than price inflation, and capital injections into the banking system are a necessity. For Koo, macroeconomic theory had to be split in two: yin theory, reflecting the conventional view, and yang theory, corresponding to his balance-sheet recession era, not far from post-Keynesian economics. Indeed, mainstream macroeconomists have also made a similar distinction with the advent of the global financial crisis: standard theory does not hold anymore when nominal interest rates reach the zero lower bound and hence when real interest rates cannot be low enough to ensure the equality between investment and full-employment saving. In Koo's view, the Japanese two lost decades of the 1980s and 1990s were a prime example of a balance-sheet recession, and so was the Great Depression of the 1930s. The 2008 book had been endorsed by Lawrence Summers as well as by Martin Wolf, the *Financial Times* journalist, and the new 2015 book again gets an endorsement from Summers as well as a new one from economic historian Peter Temin. A summary of Koo's view has also appeared in this journal (Koo 2013).

In a balance-sheet recession, the main problem is that nobody wishes to borrow and deficit spend; banks would like to lend but find no creditworthy and willing borrowers; as a consequence, the government has to step in and deficit spend, so as to crank up aggregate demand and fill the gap between the amounts of funds that private agents are saving and the amounts of funds that these same private agents are willing to borrow. In the 2008 book one could already perceive a lot of similarities with the kind of analysis being pursued by Wynne Godley and his co-authors at the Levy Economics Institute, which used the fundamental identity and emphasized the financial balances of the various sectors of the economy, that is, the net lending or borrowing of households, corporations, the public sector and the foreign sector. The similarities are even more obvious in Koo's new book, where this time he makes an explicit use of figures compiling the sectorial financial

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balances of various countries, as Godley used to do. An interesting addition made by Koo is that he splits net lending into its two constituent components, that is, the additions to financial assets and the additions to financial liabilities, thus helping us to see how much private agents are reluctant to add to their debts when the economy has entered into a period of balance-sheet depression.

Koo's 2008 book, written when subprime loans were starting to take their toll on the value of asset-based securities, did mention that the US economy was on its way to a difficult period. The author provided an additional chapter in the 2009 updated edition, mainly pointing out that, once more, rating agencies had proven to be wrong, and that the large fiscal deficits of the American federal government had not led to rising interest rates. As one would expect, there is a degree of repetition between the old and the new book, as Koo once again describes the key characteristics of his theory of balance-sheet recessions and as he recalls the lessons to be drawn from the Japanese experience. The purpose of Koo's new book is to extend his analysis to the current US and Japanese situations, the European crisis and the future challenges of the Chinese economy, all this in light of the Japanese experience. Koo, as the title of his book indicates clearly, is also much concerned about the possible future negative effects of the quantitative easing (QE) policies being pursued by central bankers.

This aspect of his book is certainly the most puzzling. Koo seems to have a very good understanding of the limits of monetary policy when private agents do not wish or fear to borrow funds and of why government expansionary policies are necessary in such situations. Koo admonishes New Keynesian authors such as Christina Romer, Ben Bernanke, Paul Krugman and Jeffrey Sachs for providing support to Milton Friedman's claim that the Great Depression was caused by a fall in the real money supply until 1933 and for believing that the Bank of Japan could easily have avoided its own stagnation episode by inflating the money supply. Koo points out that the reason that the real money supply increased after 1933 is that the US federal government launched a deficit-financed expansionary fiscal policy. The expansion of the money supply was not, initially, associated with an expansion of private credit; its counterpart was an increase in government bonds purchased by banks, as the government was the only agent willing to borrow.

Still, Koo is worried about the negative future impact of QE policies, referring to them as the QE trap, presumably as an analogy to the liquidity trap. On the one hand, Koo agrees that QE1, which Bernanke used to call credit easing, was a necessity at the outset of the financial crisis as private banks were facing huge liquidity problems and as the clearing and settlement system was on the verge of collapsing. However, Koo argues that QE2 and QE3 were useless. While these two quantitative easing operations managed to lower interest rates on long-term assets by a few dozen basis points, Koo says that they had no impact whatsoever on real investment and the real economy. In contrast to the hopes of their proponents, the latter two QE operations did not lead to any wealth effects on consumption nor to any positive effects on the inflation rate. Instead, these QE operations led to an asset bubble and they squeezed bank earnings by twisting the term structure of interest rates. Koo further argues that past and recent QE policies have been a failure in Japan, as demonstrated by the fact that the near-zero interest rates have only led to higher household saving rates, as the Japanese still suffer from a debt-deflation trauma.

Koo goes so far as to draw a graph illustrating that, because of QE, interest rates in the long-term future will be higher than they would otherwise had been without QE, and that while QE operations brought short-term gains to the US and UK economies, they will bring about long-term costs that will exceed these gains. Here it is difficult to exactly understand Koo's line of thought. His argument seems to be that financial markets fear that, unless the huge excess reserves that the QE operations have created are being unwound, they will eventually generate high inflation rates. The mechanism that he describes is based on the standard money supply multiplier, which post-Keynesians reject. Koo's beliefs are based once more on his yin and yang views of the world. In the yin phase, with the balance-sheet recession and the lack of borrowers, the money multiplier is said to be equal to zero or next to zero; by contrast, in the yang phase, when the economy will be out of the balance-sheet recession, 'the textbooks suggest that the U.S. money supply and prices could expand as much as 20-fold' (p. 90), a consequence of the multiplier process associated with large excess reserves. This is repeated in a number of places, for instance when he says that 'once the private sector completes its balance sheet repairs and resumes borrowing, [the huge amounts of liquidity] have the potential to generate tremendous inflation' (p. 102). As a consequence, Koo concludes, 'a central bank that has implemented QE must move to tighten policy much sooner than one that has not. As a result, long-term interest rates will remain higher than warranted by the economic fundamentals' (ibid.).

Koo devotes a long chapter to the euro crisis. He buys the unit labour cost story about the growing lack of cost competitiveness of the South of Europe. However, he gives a special twist to this story, going back to the information technology (IT) bubble of the late 1990s. Koo (pp. 207–208) provides two graphs showing clearly that both the corporate and household German sectors borrowed heavily in an attempt to take advantage of the IT bubble. This all changed when the bubble burst. Koo contends that Germany in the early 2000s became embroiled itself in a balance-sheet recession, as Germans drastically reduced borrowing and went into a mode of balance-sheet repairs. A weakened German economy would have required large government deficits that were prohibited by the Maastricht rules. So, instead, the ECB stepped in, and started reducing interest rates, all the way to 2 per cent. This, Koo says, led to rising wage and price inflation in the rest of the eurozone, and to a housing bubble in Spain and Ireland, as these interest rates were much lower than anything that any of these countries had ever known, while it had no effect whatsoever in Germany, as everyone there was trying to deleverage. Koo audaciously concludes from this that the ECB was purposefully creating bubbles in the rest of the eurozone in an attempt to rescue the large German economy.

With the help of his financial balances graphs, Koo shows that in turn the Spanish and Irish economies went into a typical balance-sheet recession when their real-estate bubbles got pricked in 2007. While Italy and Portugal did not get into a housing bubble, households and firms in both countries reduced their flows of borrowing at the start of the global financial crisis, while their corporations moved into true deleveraging mode in 2011, with negative additions to financial liabilities. Koo is highly critical of those, like ECB officials, who keep admonishing governments to pursue tough fiscal restraints, just as he is critical of the Maastricht rules and of all the fiscal pacts that have subsequently been endorsed within the European Community as he argues that the only sensible way to come out of a balance-sheet recession is to rely on a government expansionary fiscal policy that absorbs the excessive net financial saving of the private sector. As a number of other observers have noted, this problem is exacerbated within the eurozone, as capital flows from one kind of government bond to another are made even more volatile by the elimination of the currency risk inherent to a common currency. Koo proposes as a solution that citizens of one eurozone country be prohibited from buying securities issued by the government of another eurozone country, but that does not seem very helpful. Another proposal that he makes is that different risk weights should be applied to domestic and government debt – a more feasible solution.

While one might disagree with Koo's interpretation of the yin phase, his analysis of the yang phase – the debt-deflation stage – is certainly worth examining and pondering.

Those who have already read his 2008 book may find an excessive amount of overlap in his new book, but those who have not read the 2008 book are strongly encouraged to study his 2015 work.

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